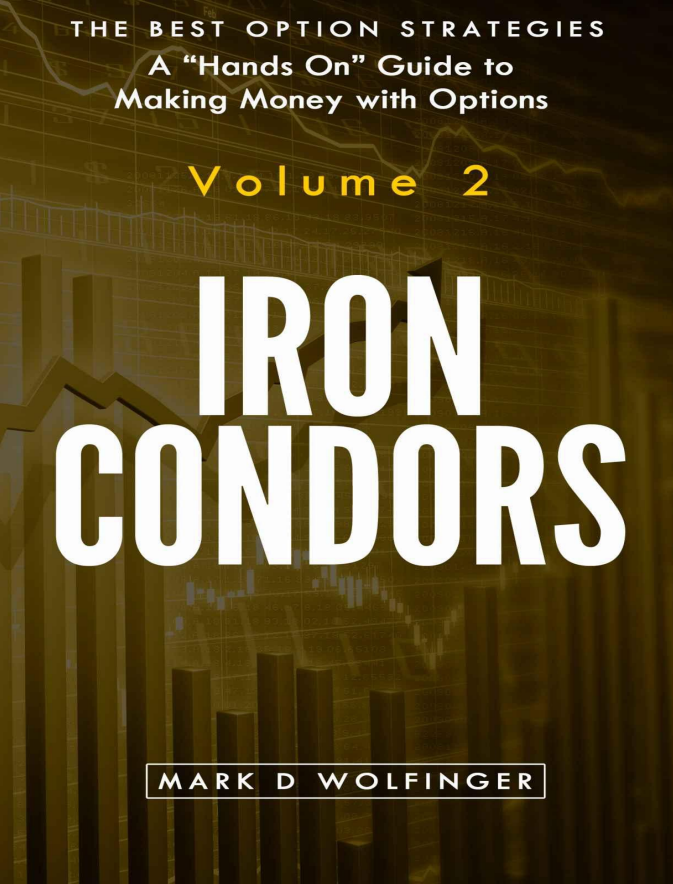


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The background of the entire cover is a dark, olive-green color with a faint, semi-transparent grid. Overlaid on this grid are several financial charts: a line graph with a jagged, fluctuating line at the top, and a bar chart with vertical bars of varying heights at the bottom. The text is overlaid on these charts.

THE BEST OPTION STRATEGIES

A “Hands On” Guide to
Making Money with Options

Volume 2

IRON CONDORS

MARK D WOLFINGER

The Best Option Strategies:

A “Hands On” Guide to Making Money with Options

Volume 2

Iron Condors

Mark D Wolfinger

Options for Rookies Books

Iron Condors

Mark D Wolfinger

Published by Mark D Wolfinger

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Options for Rookies Books

This is Book THREE in a series of educational and informative books for option traders.

Requests to the publisher should be addressed to

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Evanston, IL 60202

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Disclaimer: Although strategies involving credit spreads/iron condors can generate profits more often than traditional investment strategies, as with all stock market investments, the possibility of losing money is ever present. The successful trader understands the importance of proper risk management. Neither the publisher nor author shall be liable for any loss of profit incurred as a consequence of the use and application, directly or indirectly, of any information presented in this book. If legal advice, tax advice or other expert assistance is required; seek the services of a professional.

The Purpose of this Series of Books

These e-books are each designed to introduce the reader to one specific option strategy. This is Volume 2: Iron Condors. This book contains information for the novice as well as for the more experienced trader.

Each volume contains a thorough discussion of one, low-risk option strategy. There are no get rich quick schemes, nor promises of enormous profits. These books represent the ‘nuts and bolts’ of using options in strategies that work.

The efficient trader has more than one strategy in his/her arsenal of trade ideas and chooses an appropriate method that depends on current market conditions. Don't fall in love with one strategy, forsaking all others.

Volume 2 is for the reader who has a neutral market bias and wants to earn money from the passage of time. This strategy works best when the stock market trades within a range, and should be avoided when the market is in a steady unidirectional trend. Extremely volatile markets are difficult for the iron condor trader, but the experienced and successful trader should be able to handle most situations.

If you are encountering options for the

first time, this book is not (yet) for you. Begin your basic options education with my classic primer: The Rookie's Guide to Options, 2nd edition, 2013.

This is VOLUME 2: Iron Condors
Volume 0: Introduction to Options: The Basics
Volume 1: Writing Naked Puts

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Introduction

Iron Condors is the third book in a series that offers a hands-on education for some of the most useful option strategies. It is intended to be quite different from all other books you may have read that discuss this versatile option strategy.

One popular idea is that iron condors can be used to generate a steady monthly income stream. Although there is truth to that idea, it is a vast oversimplification. Iron condors do provide an income stream for disciplined traders who understand (a) the importance of risk management and (b) how and when to

trade iron condors.

If you have been led to believe that iron condors are a 'set it and forget it' strategy, I will try to get that idea out of your head. These positions require careful monitoring, and the frequency depends on the specific options that comprise the iron condor. It is never a position to initiate and then ignore.

Most iron condors – at least the type that I recommend as suitable for the majority of traders – require some active decision making as long as the position remains in your portfolio. Sometimes that decision requires action to reduce risk. At other times, the decision will be to do nothing and continue to hold. But

make no mistake, deciding to hold is a real decision – not to be made lightly.

Another decision involves a pre-planned (I encourage the preparation of a trade plan for each trade) exit to lock in the profit. As the trade progresses, and when the position is working and profits accumulate, it becomes a daily decision: hold or exit. It is important to avoid being greedy; it is important to recognize when there is just too little remaining profit potential in the trade to warrant holding. That is where the trade plan, and the target profit, can help you become a disciplined trader.

Closing the position may be easy and pleasurable, such as when you earn the

target profit before expiration arrives. However, it could also be a gut-wrenching decision that locks in a loss and is made because it is essential to take some risk-reducing action for a position that has not worked as planned.

Expect to learn the basic concepts of trading iron condors:

--How to
decide which
options are
suitable for
your iron
condor. There
is no single
'best' position
that suits all

traders.

--Ideas on how to manage risk.

--Figuring out when to exit. We'll discuss the pros and cons of locking in profits quickly (not a good idea) vs. holding longer (but not too long).

There is more that makes this book so special. It is not just a “how to” book. I share lessons that I’ve learned from a

lifetime of trading options (starting in 1977 when I became a CBOE market maker). I share my philosophy on iron condor trading and ideas on how a winning trader thinks. The goal is to offer guidance that allows you to develop good trade habits and to avoid falling into easy-to-adopt poor habits. We all learn more about trading as we gain experience, but some mindsets are dangerous to your longevity as a trader and it is best to avoid developing those mindsets because they are so difficult to break.

To you, the reader

This book was prepared for an audience that already understands the most basic concepts about options. Although some

of the material is suitable for rookies, if you do not understand the difference between a put and call or lack any experience trading options, I encourage you begin with the most basic concepts about options before continuing. There are numerous sources of information, but I recommend my recently updated (2013) “[The Rookie’s Guide to Options, 2nd edition.](#)”

My basic tenets

The following points represent the foundation of my beliefs, and the book is written accordingly:

--The ability to
manage risk is

the most important skill for any trader. Those who close their eyes hoping for a good outcome are destined to fail.

--If you have no knowledge of the 'Greeks,' you can still get much out of this book. However, it is mandatory for your long-term

success as an
option trader
that you take
time to
undertake at
least an
elementary
study of the
Greeks.

Understanding
the Greeks is
not difficult,
despite what
you probably
believe, and it
allows you to
recognize the
risk (and

reward)
potential for
any position.
But most of all,
it ensures that
you avoid
owning a
position (or
portfolio) that
could — in a
worst case
scenario —
result in losing
more money
than you can
afford to lose.

--Trading
without

knowledge of
how the Greeks
work places a
trader at a
tremendous
disadvantage.

--Discipline is
necessary
when managing
risk. It is one
thing to say that
you understand
what risk
management is
all about, but it
is another to
put it into
practice. It is

emotionally
difficult to pull
the trigger on
necessary
trades (that
reduce risk)
because most
of the time such
action involves
locking in a
loss.

--Let another
trader earn the
last nickel or
dime on the
position. Be
willing to pay
a small sum to

exit the
position, lock
in profits, and
eliminate all
risk.

Other thoughts on iron condors

--There is often
disagreement
among traders
and brokerage
firms about
what it means
to 'buy' or
'sell' an iron
condor. There
is a solid
rationale for

using either
term when
making the
trade, and there
is no need to
rehash the
arguments here.
I prefer the
term 'buy' but
will avoid
using either
term when
discussing the
trades.

However, you
must know
what "buy (or
sell) an iron

condor” means to your broker so that you can enter orders correctly.

-- The iron condor is most often traded as a single transaction, consisting of four legs. That is how I encourage you to enter your orders because it is more efficient.

However, it is reasonable for the more experienced trader to build the position with two separate trades (sale of call or put spread; followed by sale of the other spread). NOTE that selling the call and spreads separately is more difficulty

than it appears,
and I
recommend
against trading
this way.

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It is easy to generate profits when trading iron condors because, under normal market conditions, traders earn a profit on a majority of their trades. The trade is initiated to produce a profit most of the time (perhaps 80 to 90+%).

HOWEVER, when losses are allowed to grow (i.e., risk is ignored), it becomes extremely difficult for any iron-condor trader to earn money over the longer term. The key is to manage risk so that no single loss wipes out too many profitable trades. When the trade is expected to be profitable 90% of the

time, that means that a loss should be expected approximately one trade per ten. If that loss is allowed to reach its maximum theoretical amount, then it will be more than enough to erase the profits from the other nine winning trades.

--Using this strategy only during appropriate market conditions is essential. A strongly trending market usually leads to losses. Volatile markets are

more difficult
to manage, and
I encourage
you to avoid
volatile
markets until
you have
enough
experience to
feel
comfortable
when managing
risk.

--Failure to
recognize when
a position has
become too
risky for you to

hold, leads to large losses.

--Failure to take immediate action once you realize that risk of loss is imminent is likely to lead to realizing those losses. Sure, part of the time the losses never occur. But it is not reasonable to gamble.

This strategy is far from perfect, but is worth your time and effort to learn how to trade. It is one of the basic strategies that belong in your arsenal of trading ideas. Do not expect to use it as your only strategy.

As a reminder, this strategy is

most effective when the trader has a market-neutral bias. If you prefer to own positions that prosper during a bullish or bearish market, the iron condor is not a good choice.

NOTE: Chapter one accommodates the needs of traders who are brand new to options. After that, the text assumes that readers already possess basic options knowledge.

Part I

Background Information & General Ideas about Trading

Chapter 1

Some of the Finer Points

It is not difficult to learn the basic steps involved with setting up and trading an iron condor. This book teaches you to do that, and does so in great detail. However, because that information is available elsewhere, the major difference between this Iron Condor book and others is that the primary focus is on teaching readers to understand what they are doing, and how to make intelligent decisions.

When performing a variety of necessary

tasks, we do the best we can. We think things through, make decisions and act on those decisions. Trading is different because it is a voluntary activity. If we cannot do the job effectively (profitably) then we do not have to spend our time and effort making trade/investment decisions. Instead we can turn our money over to professionals (index funds, financial planners, etc.) and let them do their thing.

Because you and I choose to use options and other investment vehicles actively, we should want to gather enough information to do so wisely. It makes sense to begin with the basics, and then – with a solid background behind us – move onto more advanced material. We

want to make good decisions and trade in an intelligent manner. If we do that, our trading should be profitable. If we cannot outperform those who invest in index funds, there is no real purpose in trading. We can use our time to pursue a hobby.

Most hobbies cost money in exchange for the enjoyment they bring. However, investing and trading are not hobbies. They are serious undertakings. If you cannot take the time to learn how to use options to improve your financial well-being, then I urge you not to get involved. Trading is a serious business for serious people.

To that end, I share the thoughts of an

experienced trader with the hope that you will gain an excellent understanding of the overall iron condor strategy. There is a significant difference between being able to mechanically make the trades and having the ability to make good (getting sufficient reward potential for the risk being taken) decisions. Although this book can be read by traders who are fairly new to options and have some trading experience, it is not intended to be your introduction to options.

Some of the ideas stressed in this book are:

--When it
makes sense to

trade iron
condors and
when it does
not.

--The
importance of
managing risk.
The sum at risk
must never be
large enough to
demolish your
portfolio. You
can recover
from losses,
but it is
impossible for
most traders to
come back

from ruin.

--The
feasibility of
allowing the
options to
expire
worthless and
thereby seeking
the maximum
profit (holding
to expiration)
vs. exiting
early to lock in
profits and
eliminate risk.

--

Understanding

why some
positions are
equivalent to
others and that
it truly makes
no difference
which of those
'essentially
identical
positions' you
decide to trade.

-- The
importance
portfolio
cleansing
where you
eliminate any
position that

makes you
nervous.

Trading
requires
making
winning
decisions and
accepting risk
(there is no
reward without
some risk or
everyone
would be a
trader).

However,
taking that risk
must not leave
you being

uncomfortable
or result in lost
sleep because
nervous traders
make rash
decisions.

--The
desirability of
owning iron
condor
positions with
a relatively
narrow spread
width (defined
as the
difference in
the strike
prices between

the two calls—
or the two
puts). In other
words, do not
own wide iron
condors
without a good
reason.

--Believing
that the iron
condor is a
single position,
consisting of
four legs. It is
constructed by
selling one call
spread and one
put spread on

the same
underlying
asset. All
options expire
at the same
time.

*****The trader's
objective is to
earn a profit
on the whole
iron condor. It
is not to seek a
profit from
the call spread
and another
from the put***

*spread. ***

--

Understanding that it is far more efficient to manage the iron condor as if it were two positions (call spread and put spread), but that your profit objective is based on owning a single position.

Do not ignore the call spread to grab a quick profit on the put spread. This is a 'must-be-understood' concept.

--The importance of managing risk (there is no limit as to how often this should be repeated).

--Etc. There

are many ideas
that I share
with readers,
each of which
is intended to
make the
overall trade
plan
successful. We
do get to the
specifics of
trading, but I
encourage you
to have
patience and
read this book
chapter by
chapter. It is

possible for
you to develop
difficult-to-
break losing
habits by
getting started
too quickly.
One of the
well-
understood
facts about
traders is that
discipline is
difficult to
maintain and
bad habits are
very difficult to
break (because

it may never occur to the trader that his standard operating procedure is flawed).

Do not get the idea that I am preaching. I sincerely want to share some of the lessons I learned over the past (almost) 40 years. There is no reason for

each trader to
make the same
mistakes when
they can be
avoided.

Chapter 2

The Iron Condor

Terminology

To avoid any possible misunderstanding, let's clarify some terminology.

A vertical spread consists of two calls or two puts. Both options expire at the same time and are on the same underlying asset. When both options are calls, it is a call spread. If both options are puts, it is a put spread.

Example

When buying a spread, you buy the higher priced option (the option with the larger delta. Delta is one of ‘the Greeks’) and sell the lower priced option. For that reason, buying a spread always result in the expenditure of cash. Thus, when buying a vertical spread, the trade may be referred to as buying a debit spread.

Example

Examples

These two spreads have been sold. Each is a vertical spread. Each is a credit spread. The first is the OFR Jul 18, 2014 60/65 call spread and the other is the OFR Jul 18, 2014 50/55 put spread.

The trader who entered these orders (the orders were filled) collected cash when

selling the call spread and collected more cash when selling the put spread.

NOTE: There is a big difference between ‘collecting cash’ when the trade is made and earning a profit. At some point in the future (no later than expiration day) the trader must buy the spread(s) just sold. When selling a spread, the trader earns a profit only when it can be bought at a price lower than the original sale price. Part of the time, both options in the credit spread expire worthless and the trader gets to keep every penny (minus commissions) of the original sale price.

The iron condor

When the trade consists of the sale of one call spread and one put spread – as in the above example using the two OFR spreads – and when the following are true, the position is a typical iron condor:

--When both spreads expire at the same time.

--The call and put options that were sold

--Have similar Deltas or

--Are roughly equally as far out of the money

--When the underlying asset is identical for each spread.

--When an equal quantity of each spread is sold (4-lots, in this example).

--When the spread width is

identical.

--The spread width is the difference between the strike prices of the options that comprise the spread.

--The call spread width is five; $(65 - 60)$

--The put spread width is five; $(55 - 50)$

NOTE:

Those are the only strike prices that matter. The difference between the put and call strike prices is immaterial. In fact, as long as that difference is not zero (i.e., as long as the short put spread and the short call spread do not have one strike

price in
common) the
position is an
iron condor.
When they do
have a common
strike, then the
position is an
iron butterfly.

**Example
of an iron
butterfly:**

Those are the requirements for a position to be an iron condor. However, it is very important for every reader to understand that you are free to trade any position that suits your needs. In this book, I write about true iron condors (i.e., positions that meet the above requirements), however, you may construct your position differently. Keep in mind that such minor changes may affect the name of the position that you own, but it should not have any effect on how you think about making the trade and managing risk.

TIPS for the thinking trader:

When you have a good reason to modify the iron condor, you may choose one of these ideas (or use your imagination):

--Sell more call spreads than put spreads; Sell more put spreads than call spreads. This adds a bearish or bullish bias to the position.

--One of the spreads is farther out of

the money than the other. This adds a bearish or bullish bias to the position.

--Use different expiration dates for the call and put spreads.

When making the trades, it is common for traders to open the entire position in a single order. I encourage you to adopt that method. However, there is nothing wrong with ‘legging’* into the position.

*Legging refers to trading part

of the planned position first, and then trading the other part at a later time. Legging into iron condors is often done ineffectively, and I discourage adopting this technique.

Before discussing ideas on how to enter the trade, adjust the position when necessary, and make the all-important decision of when to exit the iron condor

(to lock in a profit, reduce risk, or take a loss) let's look at some of the ideas about iron-condors that most writers never bother to mention.

Chapter 3

The Winning Iron Condor Mindset

All traders are most interested in learning the basic ideas about how to initiate the trade. That is typical human nature. You cannot earn money without trading, thus (the common thought goes) learning how to initiate trades becomes the overriding objective for any new trader.

I believe that learning to manage risk is far more important to your future financial success than learning how to

open positions. Thus, risk management is not a topic you can ignore. In an effort to present the iron condor story in a logical sequence much of our discussion about managing risk must wait until you learn how to construct and trade an iron condor.

Before learning how and why a trader opens an iron condor position, let's look at some special thought patterns (what I refer to as a trader's mindset) that can help you have a better understanding of the subtleties of iron-condor trading.

I encourage you not to skip this material. If it does not make sense at this time (because you do not yet have a good feel for how iron condors work) then it will

certainly make sense later. However, just being aware of these concepts at the very start of your iron condor education will help get you started on the right track. Avoiding mistakes is an essential part of any trader's education.

For readers who understand the basics of iron-condor trading, this material is likely to present thoughts that may not have occurred to you. I'm offering these thoughts upfront, rather than later, to help you avoid developing poor habits.

Thought #1: There is more than one way to manage an iron condor

Any position that meets the requirements listed in the previous chapter is an iron

condor. Positions that are slightly modified may not be 'true' iron condors, but they should be managed as if they were. In other words, if you elect to sell five call spreads and six put spreads, the everyday risk-management decisions are the same as if it were a true 5-lot iron condor.

For discussion purposes (see below) I recommend classifying iron condors into four separate categories (below) because the specific risk management techniques used are significantly different for each category. We'll take a closer look at that when we discuss how to manage iron condor positions. But for now, the material is presented as if all iron condors were created equal.

To be certain that we are all on the same wavelength, let's assume that we are referring to iron condors where

--The underlying asset is an index, rather than an individual stock.

--The index price is much higher than that of typical stocks, perhaps 1,000 to 3,000.
Examples

include SPX (the S&P 500 Index trading near 1,900); RUT (Russell 2000 Index, trading near 1,200); NDX (Nasdaq 100 index (3,800).

--The spread width is 10-points and the maximum possible loss for a one-lot iron condor position is

\$1,000, minus the premium collected.

--When trading an iron condor, you sell one call spread and sell one put spread, and always collect a cash premium when opening the position. Thus, the iron condor consists of two credit spreads. There is no

discussion in this book about the opposite strategy which consists of buying two debit spreads. We make trades of that kind only when exiting our iron condors.

Thought #2: Different iron condor types:

--Far OTM,
very small

premium, iron
condors. These
are popular
among some
traders because
money is
earned (too
little, in my
opinion) in the
vast majority
of the trades.
However,
when losses do
occur they are
often large
enough to wipe
out years'
worth of

profits. I urge you not to trade this type of iron condor.

--All four options in the iron condor (IC) are reasonably far out of the money and have a low delta (less than 3).

--The premium available when selling the call

and put spreads
is small,
perhaps \$0.05
to \$0.15 each.
Thus, the profit
potential is
small.

--The
probability (at
the time when
the trade is
made) that all
options will
expire
worthless
(resulting in a
profit) is 94%
or higher.

--Close-to-the-money (CTM) iron condors. Because 'close to the money' is a relative term and is defined differently by each trader, for the purposes of this discussion I'm defining CTM options as those with a delta* of 20 to 35.

NOTE: The

delta* refers to the delta of the option sold because that is the specific option that represents your risk. If that option moves into the money, or threatens to move into the money, the position will probably be underwater (losing money) and have

become
uncomfortable
to hold (the
probability of
incurring
additional
losses is high).
The option
bought is of
less
importance in
the overall
scheme of
things, because
its sole
purpose is to
limit risk.

--Please do not

think of the option bought as an income source. If this option is worth more than you paid for it, that is not a good sign. Why? Because the option sold always gains value more quickly than the option bought. In other words, when this options gain

value, that is bad for the iron condor owner. Profits are earned when all options lose value over time.

--The premium generated is high, allowing for the chance to earn a very significant profit. For the 10-point iron condor, the premium can

be \$300 to \$450. The actual premium collected depends on various factors:

--Real market conditions (especially volatility).

--Time until the options expire.

--Strike prices chosen (higher delta options offer higher

premium).

--Traditional iron condors. This refers to the typical iron condor chosen by the vast majority of traders. There is no specific set of guidelines to establish a definition for a traditional iron condor (but we will discuss some good

choices for newer traders later in this book), because the iron condor trader must:

--Be comfortable with the risk of owning the position.

--Be willing to accept that risk when seeking the available reward.

--Believe that

the underlying index is likely to trade in a narrow price range (between the strike prices of the options sold) during the lifetime of the options.

--Very short-term iron condors. These are positions that expire in one or two weeks. Time

decay is rapid
(good for the
trader), but
negative
gamma
(another of the
Greeks)
presents high
risk for the
trader).

Why be
concerned with
different types
of iron
condors?

--Each of these
iron condors

requires a
slightly
different way
of thinking
when it comes
to managing the
position.

--The wider
the variety of
iron condors
available for
trading, the
better your
chances of
discovering the
one or two that
are best suited
to your

personal
investing style
and tolerance
for risk.

--However, it
is too early to
be concerned
with the
specific types.
Just be aware
there are plenty
of iron condor
varieties.

**Thought #3: The iron condor is one
position**

The iron condor is one, and only one,

position. For some traders this is a difficult concept to grasp. It may seem logical to think of the position as consisting of two credit spreads. The problem with that way of thinking is that it often results in poor risk-management decisions.

Example

Bottom line: You traded one iron condor and collected \$2.30. Let's say that a few days pass and the underlying index has moved higher. The call spread is worth \$2.00 and the put spread is worth \$0.60. You are losing money at this point because you must pay \$2.60 to exit and that is \$0.30 more than you collected to make the trade.

We will discuss how to handle the 'what should you do now' decisions later, but for now the vast majority of iron condor traders would (correctly) do nothing and hold the position as it exists.

The inexperienced trader who looks at the iron condor as two positions could

easily believe that there is a \$0.60 profit on the call spread. Because that represents 50% of the maximum possible profit from selling the call spread, this trader is tempted to buy (to close the position) the call spread, thereby locking in the \$60 profit. This is a big mistake and something that the successful iron condor trader must learn to avoid.

*****FACT:***

***There is no
\$60 profit.
The position is
currently
losing \$30. If***

*you can look
at the iron
condor
position from
this
perspective; if
you
understand
that there is
no profit; then
you have gone
a long way
towards
understanding
how to
manage the
position.***

The key takeaway from this section is described by combining the following thoughts:

--The iron condor is a single position containing four different options.

--The call spread is not sold as an income source. It is sold as a hedge against being short the

put spread. You do not make money by covering (closing or exiting) the call spread at less than you originally received.

--The put spread is not sold as an income source. It is sold as a hedge against being short the call spread.

You do not make money by covering the put spread at less than you originally received.

--You sell both spreads as a single income source. You earn profits by closing the whole iron condor and paying a smaller premium than

you collected
when making
the trade.

Thought #4: How the Iron Condor Traders Earn Money

The iron condor earns money when either or both of the following occur:

--Time passes
and the
underlying
asset does not
threaten to
move past the
strike price of
the options you
sold.

--Implied volatility declines, decreasing the value of both puts and calls.

Once the iron condor loses value and can be purchased at less than the premium collected, the trade can be closed at a profit. More detail in the next chapter.

Chapter 4

Iron Condor Theory & One Trading Rule

Once the underlying has been selected, the crucial decisions remain. Consider the following bullet points to be introductory statements with details to follow.

Finding an iron condor position:

--Which calls
and puts should
be sold?

NOTE:

Choosing the spread to sell is the ultimate objective, but picking the option to sell is truly the important part of the trade.

--What is the proper spread width?

--It may seem 'obvious' that a trader should select the

specific option
to buy just as
carefully as
he/she chose
which option to
sell. However,
that is not true.
The most
efficient
method for
trading iron
condors (or
selling credit
spreads in
general) is to
select the
spread width
(which defines

both options).

-- Finding an appropriate expiration date

--Short-term (1-2 weeks) options have to be handled differently than longer-term (2-3 months) iron condors.

Therefore some discussion (next chapter) must be

reserved for
selecting an
appropriate
expiration date.

Iron Condor Theory

When trading an iron condor, we expect time to pass and the market to be non-volatile. If that is not the stock market that you expect to see, then it is the wrong time to trade iron condors.

When our expectations come true, it becomes profitable to close the position.

NOTE: If time passes, and the underlying price remains reasonably constant, then either the call spread or the put spread, or both lose value. This

happens because the value of OTM options approaches zero as expiration nears, unless the strike price of the short option (of the call or put spread) is threatened (significant chance that the option will be ITM).

As time passes and expiration day draws closer, the chances of the underlying being able to make that move declines. Thus, the value of the options must decline.

I hope it is understood that the spread loses value because the more expensive option (the one you sold) loses value more quickly (it has a higher theta) than the option owned. That shrinks the value of the call and put spreads, resulting in

a profit.

At some point, the trader accepts the profit and exits. The general idea is: Time passes, nothing bad happens to the price of the underlying stock or index, and the trader earns a profit.

Of course it does not always work that way. When the underlying does undergo a significant price change, then the trader may decide to exit the position, even though it involves locking in a loss. That is done to prevent a larger loss. The rest of this discussion is withheld until we talk about risk management in Chapters 17-18.

General thoughts

The option spreads that you sell are out

of the money (OTM) and you want them to remain OTM. The best way to achieve that goal is to sell options that are far OTM.

--However, it is not that simple because the maximum possible profit is the cash collected from selling the call and put spreads.

--When the spread is too far OTM, the

premium is small.

-- When the premium is too small, the potential profit is often insufficient to justify taking the risk necessary to earn the profit.

These two ideas are in conflict with each other.

You do want a high probability of earning a profit. However, this trade

involves risk and there is no point in taking that risk when the reward is too small.

As you trade more iron condors you will get a good feel for a both the minimum acceptable premium—one that suits your trading style—and a desirable delta for your options being sold. (NOTE: Smaller delta options are farther out of the money). But for now, let's assume that we will not accept less than \$0.40* for a 10-point call spread or a 10-point put spread on an index.

*A guideline,
not a rule.
Some traders
do settle for

less. There is nothing wrong with that for the right trader.

Therefore, when selecting an iron condor to trade, there is always a trade-off, or compromise.

You want some flexibility and do not want to be trapped into a set of rules that is uncomfortable

for you, so let's
begin with this
rule:

My trading rule:

I believe that discipline is necessary for success, but am not a big fan of ironclad trading rules because a little flexibility is desirable. However, I do believe traders should adopt this rule:

*****If it is
uncomfortable
— for any
reason — to
own a specific
position, then
do not own it.***

This may seem trivial, but you would be surprised by how many people feel that they are ‘forced’ into holding a position for the simple reason that they are unwilling to exit a trade that would result in a loss.

This is destructive thinking. Please take my word for it: You will have many losing trades when trading this, or any option strategy. Your financial success as a trader does not depend on how many losing trades you have. Instead it is based on the size of those losing trades. More on this in Chapter 17.

--Getting out of

the trade suggests that the original trade decision was a mistake, and traders do not like to admit to making mistakes.

--Believing that all losses result from mistakes is another destructive mindset. You must make the

best decision
you can make
at the time a
decision is
needed. That is
all you can do.
Some
decisions lead
to profits and
some lead to
losses. Taking
a loss does not
mean that you
made a
mistake. It
means that the
decision did
not work well

this time.
Remember that
a decision that
has a 95%
probability of
leading to
success also
means it will
fail one time in
20. When that
happens, the
trader did not
make a
mistake.

--Do not be
concerned with
making
mistakes. That

is part of the learning process. Do be concerned if you make the same mistake repeatedly.

Your gut cannot predict where the stock market is headed, but it does express an opinion. When it makes you nervous to hold onto a trade, then please do not hold it. If it frightens you to hold onto a position, and you are too stubborn to exit, then I believe that your success as a trader is in serious doubt.

Preliminary risk-management lesson: When you make a decision that is good

(right for you) at the time the decision is made, do not dwell on it. Do not track whether it was the winning or losing decision.

Trading involves living in the world of statistics. Much of the time, events occur as anticipated. But not always. There will be minor and major unexpected events in your life. Accept that as fact and do not beat yourself up over what you could have done differently. Live in the real world.

Chapter 5

Steady Monthly Income

One of the commonly accepted ideas about the iron condor is that it is an ideal strategy for generating a steady monthly income. Those who promote such ideas are doing a disservice to their readers. In my opinion, the truth is:

Iron condors can provide steady monthly income, but only when you, the trader, are:

--Disciplined
and understand
when to exit a

losing trade.

--A skilled risk manager. The basic risk management skills taught in this book are sufficient for the newer trader. As with anything you learn in life, additional study can improve your skills.

However, too many people

believe that it
is too difficult
to understand
risk
management
and they ignore
this essential
aspect of
trading.

--Capable of
adopting the
strategy only at
appropriate
times. The
primary rule is:
this is not a
bread-and-
butter strategy

and it should not be used every month.

--There will be times when the market is trending too hard in one direction or the other. Under those circumstances, iron condor traders soon discover that no call or put spread is far enough out of

the money to allow the trader to hold onto the position and still remain within his/her comfort zone.

--When IV (implied volatility) is high, premium is high and that is a good time to trade iron condors. [See Chapter 6.](#)

--Not greedy I.
You must understand that a few consecutive winning months is the norm and that obtaining such results has not turned you into a master iron condor trader.

--Not greedy II.
Recognize when the residual profit potential is too

small for the risk involved. Allow another trader to collect the last couple of nickels from the position.

--Not lazy. Do not expect to initiate trades, wait for time to pass, and then be allowed to exit with a good profit. Expect to work.

Recognize that you may have to make many decisions (deciding to hold is a decision) over the lifetime of any given trade. It is true that you will find that some trades work perfectly, but many require your full attention.

Chapter 6

Trading Iron Condors in a Rising Volatility Environment

As mentioned, it is a good idea to trade iron condors when the implied volatility is high because the trader can collect a significantly higher cash premium than when IV is low. It is also true that a volatile market increases the odds that the market will move too far and require that you make an adjustment to avoid a large trading loss. However, the increased premium is often sufficient to

compensate the trader for the extra risk.

When to take advantage of high IV: The winning plan

High IV is good for the iron condor trader, especially once it begins to level off and decline. That is when premium remains high despite the fact that the market has started to become less volatile.

Rising IV is not so good. Clarification: When you initiate an iron condor trade and IV continues to rise, that is likely to result in difficulty when it comes to managing the trade. Why? Because increasing IV means that the iron condor position premium is increasing – and your current trades would be

underwater.

IMPORTA

NOTE: It may be ‘only’ a paper loss because the trade has not yet been closed. But it is still a loss. Do not fall into the common trap of believing that there is no loss until a trade has been

closed. When
the net
liquidation
value of your
brokerage
account
declines, you
lost (past
tense) money.
When it
increases, you
earned money.
As long as the
position
remains open,
gains and
losses come
and go.

The rising IV vs. high IV statements may seem to be a contradiction, but it is not. For example, long-term average implied volatility (IV) for index options is roughly 20. When IV is 25, iron condor traders are pleased with the corresponding premium increase and begin to feel good about their positions. And they should.

However, when the markets are more volatile and when daily price swings are larger, it may be the beginning of a significant change in how traders feel about the future of the stock market. In other words, there is always the possibility that an increased demand for all options will drive IV higher. If you

get excited (i.e., greedy) and double the size of your usual trade -- because IV increased to 30 from 20 -- you may soon discover that IV has zoomed past 50 and that you lost a lot of money from your newly-opened positions. Not only that, but losses are larger because you own larger positions. Worst of all is that IV is 50 and you may be forced out of your current positions, instead of being able to initiate new trades.

The best approach is to be patient and increase position size gently (by 10%, from 10-lots to 11- or perhaps 12-lots when IV reaches 25 and maybe another 10% when IV reaches 30). But beyond that, when IV continues to rise, you must be prepared – just in case this is one of

those times when IV explodes and reaches extremely high levels (60 to 80). You cannot afford to own too many iron condors during that IV rise. It could literally put you out of business by destroying your trading account.

Thus, once you increased size by 10 to 20% during an initial IV increase, have the patience to wait until the data tells you that IV has topped and has begun to decrease before trading even more size. You may miss the best opportunity, but you will also have missed 100% of the opportunities to enter into a money-losing trade. When you see an apparent IV top, it is much safer to trade a few more spreads. But do not get greedy. Be aware of potential losses -- IV may rise

again after a brief pause.

The moral of the story is simple to understand but almost impossible for the undisciplined trader to put into practice. When IV rises, it is time to consider trading iron condors. If you already own iron condors, it pays to be patient before you become more aggressive.

However, if market volatility and IV continue to rise, discontinue that aggressive streak. It is far better to wait, devoting your time to managing existing positions. The time to become aggressive is after IV appears to have reached its maximum; after IV has leveled and started to decrease. That spares you from the pain and suffering

that comes with a large portfolio of iron condor positions in a rapidly rising IV environment.

There is no need to take extra risk unless you are truly prepared to do so. The whole point of using options as your primary trading tool is to minimize the sum of money at risk and to increase the probability of owning profitable trades. Just as with the stock market, your goal should never be to buy the bottom or sell the (IV) top. I urge you to construct a trade plan that describes ‘earning money with appropriate risk’ — and not ‘earning the maximum possible amount’ — as the objective.

Part II

Nuts & Bolts of Trading

Iron Condors

Introduction to Part II

In the following chapters I offer suggestions about a variety of items when designing the specific iron condor to trade.

There is a ton of material here, and much of it may be overwhelming to the person who is encountering options for the first time. As mentioned, those brand new option traders should not begin their education by learning about iron condors, especially when the discussions are targeted to traders who have some trading experience. It is far more important to get a solid foundation in the basic concepts before spending

your time selecting which strategy to trade.

The objective in offering so much detail is to make it clear to every reader that trading is not as simple as:

--Step one:
Initiate a trade

--Step two:
Close the trade
and bank the
profits.

NOTE: It is
not necessary
to have a full
understanding
of each idea

discussed
before you
begin trading.
However, it is
important to be
aware of how
many things a
trader can
consider when
plying his/her
trade. Use as
few or as many
of these ideas
as makes you
comfortable.
Just be aware
that no strategy
is good enough

for you to expect to earn money without a significant effort.

Suggestion:

Read all of Part II to get an overview.

Next, re-read more slowly to allow for a better understanding.

Concentrate on chapters that deal with the top decisions:

Chapter 13; Choosing Strike Prices

Chapter 14; Choosing the Spread Width

Chapter 15; Choosing the Expiration

Chapter 16: When to Exit

Let's begin at the beginning and think about entering orders. One problem with trading options is that the bid/ask markets can be very wide (i.e., the ask price is much higher than the bid price) with many stock or index options. I offer suggestions on how to overcome this difficulty.

If you trade options where the bid and ask prices are very close to each other, then you will not have to be overly

concerned with the contents of the next chapter.

Chapter 7

Navigating the Bid/Ask Spreads

In this chapter, I often use the phrase “option to sell.” That does not suggest selling the specified option and then buying another option to complete the spread. Instead, that phrase encompasses all of the following:

--When trading iron condors, you sell one call spread and one put spread.

For each of those spreads, the procedure is:

--First, choose which call or put option to sell.

--Second, choose which options to buy based only on the desired spread width. A complete discussion of spread width

appears in
Chapter 14.

--Third, enter
an order to sell
the call spread,
the put spread,
or both spreads
simultaneously
(that's the
complete iron
condor). Do
not enter an
order to buy or
sell single
options – only
trade spreads.

The contents of this chapter will have a

real influence on your results because they explain how NOT to give away your money.

Every time we make a trade, we lose money to slippage. That term refers to the fact that we are customers and not market makers and we pay prices nearer to the ask when buying options and collect a premium nearer to the bid when selling.

You can enter a bid at any price level, and there is a small (but finite) chance of getting filled at that price. This is true for both spreads and orders for single options. However,

*****When you want to buy a call option (or other bullish position) at a low price (near the bid), it is unusual to be filled at a time when you will be pleased.***

If the underlying asset price declines, then your 'low bid'

*for a bullish position may become the 'ask' price and your order would be filled at that time. ***

The point of this discussion is that the customary price at which our orders are filled is a small amount worse than the midpoint (the price equally between the bid and ask prices). This 'small amount worse' represents the 'slippage.' Every time we trade, we give up some cash because of slippage.

One way for retail traders to deal with the difficulty of facing a wide bid/ask spread is to think about the option price as being the midpoint (i.e., average of the bid and ask prices) – and then being willing to pay a bit more (or accept a bit less) when trading. I define ‘a bit’ as five-cents. But it can be 10-cents when dealing with options priced above \$2. This is far better than paying the ask price or selling at the bid price. It is typical for newer traders to fail to recognize that the markets are auction markets and that there is no need to pay the ask price when it is far above the bid price.

When your order is filled at that ‘near-the-midpoint’ price, you won’t have that

sinking feeling that you are already losing money on the trade.

Getting market quotes

--Always use live data. Never enter a live order when using delayed data. If you choose to look for trade possibilities when the markets are closed, please recognize that prices may be

VERY different
when the
market opens
the following
morning.

--Look at the
market (bid
and ask prices)
for each option
that you may
want to trade
as part of a
spread. For
example, see
[figure 8.1](#).

--Examine a
variety of

calls/puts. I encourage basing your decision on which options to trade according to the option delta. [If you are unfamiliar with the term 'delta' or 'the Greeks' in general, then you are not yet ready to trade iron condors (or almost any

other strategy).
Take a few
minutes to
understand
[what delta is](#)
and what it
measures.]

When you are new to trading iron condors, it may be difficult to understand the rationale behind the suggestion to structure the call and put spreads such that the short option has a 10-delta (or 7 or 15 or any other value). The bottom line is that the experienced trader can look back on his/her trades and recognize that some trades were more profitable than others. When that data suggests that 10-delta options work

better than 15-delta options, then the trader naturally tends to adopt the “10-delta iron condor” strategy.

Please understand that the above paragraph refers to a specific trader who exercises his preferences when managing the iron condor. If that trader finds that the 10-delta iron condor works for him, it does not mean it will work for you. We all have different skill sets, we all have different comfort zones and that means:

*****There is no such thing as the “best” iron condor to***

*trade. ***

Newer traders have some work to do to reach the stage of having a good feel for choosing the specific options to trade. The decision is based on your personal risk tolerance, profit objectives (aggressive vs. more conservative), and your ability to manage risk. Go with something that feels comfortable (you are not overly worried about losses), trade small size, and get some trades under your belt.

--Suggestion
for new traders
when using
index options:
Sell option

spreads for which the short option has a delta is between 6 and 9. Complete the spread based on your chosen spread width (Chapter 14).

--Discussions on the thought process behind choosing an appropriate delta occur frequently

throughout the book.

Getting Market quotes for spreads

Some concepts will be ‘obvious’ once you begin trading spreads (call spreads, put spreads, or iron condors). That comes with experience. I include some of those concepts below to help you understand the concepts more quickly. That should translate into saving money.

I recommend (when trading high-priced index options, such as SPX) using spreads where the option bought is 10-points farther out of the money than the option sold. Alternative ideas are discussed in Chapter 14.

Once you have your list of options to sell, look at a bid/ask quote for the specific spreads ([see figure 8.2, for example](#)) that you may want to trade.

--Specific call spreads, as in [figure 8.2](#)

--Specific put spreads ([figure 8.2](#))

--The whole iron condor after you decide which call and put spreads to trade. No

examples are illustrated.

Broker trading platform: If you do not know how to use your broker's trading platform to obtain current spread quotes, or to enter orders, call customer service and request instructions. Do not lose money by entering orders incorrectly. Practice using the platform until you know how to use it. Most platforms are easy to use, but others come with unexpected difficulties.

Plan to buy or sell an iron condor. Be very careful. My broker labels the trade as 'sell an iron condor.' However, other brokers refer to this as a 'buy.' To be certain you get it right:

--Set up a paper-trading account and make some trades. Then examine the positions and be certain you own the desired position. Don't get overconfident here because some broker platforms can be confusing.

--Be certain

that cash was collected for the trade. When selling one call spread and selling one put spread, you collect cash.

--Be certain that you sold an option with a higher delta (than the option bought) for both the call and put spreads.

Look at the market quote for the iron condor.

Determine the midpoint (of the bid and ask prices). If that price

(premium) is too small and unacceptable, there is little you can do other than have patience or find a different iron condor to

trade.

Once you find a potential trade, enter an order at a price that is ‘five cents worse’ than the midpoint. Because the iron condor is a credit spread and you are collecting cash, ‘five cents worse’ means that you are accepting \$0.05 less than the midpoint price.

Example

After some time passes, depending on the target price for the trade (and your patience to wait), you may have to lower your limit price by another five cents to ‘ten cents worse than midpoint.’ In this

example that would be \$1.50.

Be careful not to lower your price so many times that your execution price is no longer acceptable. No trade is so good that you can afford to accept any trade execution available. Always have a limit on how much you are willing to be paid to trade the iron condor.

Market conditions change over time and although you will get filled at 'ten cents under midpoint' often on some days, at other times you may have to go as far as 'twenty cents under.' Please know your true price limit and if you cannot make the trade at a price that works for you, it is better to skip the trade and try again the next day.

I suggest getting started by refusing to move more than 20 cents beyond the midpoint. As you make more trades, you can use your own judgment on where to set your minimum acceptable price.

It is easier to get an order filled when the underlying asset has options that are actively traded (high volume). SPX, NDX, RUT fill that bill. In addition, the ETFs based on those indexes are also very suitable for trading (SPY, QQQ, IWM).

NOTE: One SPY option is 1/10 as large as one SPX option, and the

premium is also 1/10 as much, and the options have strikes that are 1-point apart. Please be sure that you understand:

Ten 1-point SPY spreads is nearly the exact same trade as one 10-point SPX trade.

SPECIAL

NOTE: SPY

options trade with very narrow bid/ask spreads. If the bid/ask spread is 10-cents wide, that is equivalent to seeing a market that is \$1 wide on an SPX option with the strike price that is 10x as large.

EXAMPL

Although SPX does is not valued at exactly 10-times the value of SPY, they are close enough to make these points:

--Buying 10
SPY Jul 190
calls @ \$1.49
is essentially
the same as
buying one
SPX Jul 1900
call @ \$14.90

--The SPX call
has a midpoint
of \$14.85 and
it is okay to bid
5 or 10 cents

over that price.
But:

*****The
midpoint for
the SPY
option is
\$1.485 and
YOU MUST
NOT BID 5-
CENTS OVER
THAT PRICE.***

***The
recommended
starting
increment is
one-tenth as***

much, or one-half cent (\$0.005) to one cent (\$0.01). That translates to bidding \$1.49.

Important
NOTE: On many occasions, the bid/ask market quote is so wide that the bid for a

spread can be less than zero. Please recognize that this quote is coming from a computer and not from a real person. Why is this important?

If you see a market quote for a spread that resembles:

Bid: \$-0.80; Ask: \$2.00; Midpoint: \$0.60

The midpoint is not \$0.60.

Always assume that the bid for any option or any spread is at least \$0.00. Thus, the quote becomes \$0 to \$2 and the midpoint is \$1.00. In fact, you could assume that the true bid is some low price, perhaps \$0.20. That increases the true midpoint to \$1.10.

If this is a spread that you want to sell, do not try to sell near the 'fake midpoint' of \$0.60. Instead, use the more realistic midpoint of \$1.00 or \$1.10.

In this situation, never offer to sell your spread at \$0.55. Begin with an asking price that is based on the true midpoint, \$0.95 or \$1.05 in this example.

Don't take shortcuts. The price at which

you buy and sell does make a difference in your long-term results. Look at the quotes for the individual options and also the quotes for the specific spreads of interest. In some instances, the spread quote will be more favorable than the quotes for the individual options.

Once again, a crucial point is that you must ignore all bids below zero. This is not a trivial matter. It is likely that your broker's midpoint calculator does not take this precautionary step.

I understand that you are anxious to begin. And it is acceptable to take a little less premium on any given trade — but only as tuition cost for an education. Do not get into the habit of forcing

trades.

One additional subtle point

When you look at the quote for the spread, be certain that the quote is based on the quotes for the individual options; otherwise the midpoint may be unrealistic.

Example: Selling a call spread

Market for call that you plan to sell:
\$3.00 to \$3.60

(Note this abbreviated format for a bid/ask quote. The bid price always comes first and is smaller than the ask price.)

Market price for the option you plan to buy: \$2.10 to \$2.60

--The bid is
\$3.00 minus
\$2.60

--The ask is
\$3.60 minus
\$2.10

Theoretical (extra wide) bid/ask quote for the spread: \$0.40 to \$1.50. That makes the spread midpoint \$0.95.

However the quote for the spread could be: \$.40 to 1.00 because someone is trying to make the same trade as you, i.e., selling the spread. That person is offering to sell at \$1.00, making the midpoint appear to be \$0.70 when it is really \$0.95.

Thus your sale price should be based on the wide market (\$0.40 to \$1.50; midpoint \$0.95 and not on the ‘apparent spread quote’ of \$0.40 to \$1.00; midpoint \$0.70). If you end up selling such spreads at \$0.65 instead of \$0.90, it will be difficult to make money.

It may feel like a waste of time to verify the ‘true’ spread quote, but it is not. Wide bid/ask spreads can kill any trader’s ability to earn money. Therefore, it is essential to understand the markets to avoid paying too much or accepting too little for any trade.

It is almost never necessary to take immediate action and you can afford to try one price — even for as little as a

few seconds — before sacrificing another five or ten cents.

If you accept the cautions mentioned in this chapter, you will save yourself a lot of trading over the years. It is far too easy to let success blind you to the necessity of not tossing cash into the trash. Be careful when entering orders.

Chapter 8

Trade Screens

Many discussions in the book use the numbers that come from figures 8.1 and 8.2.

Live data; 1/24/2014 10:15am CT; RUT:
1148.35 bid/ 1148.40 ask

Undr...	Description	Nt Pr	Bd Sz	Bid	Ask	Ask	Last	Mid	Implied Vol %	OI	Delta
		Ac Ac	TIF	Country	Country	Sbs	Lmt Price				
Feb 20, 2104 PUTS											
RUT	Index						1148.35			606K	
RUT	FEB 20 '14 1010 Put		53	1.80	1.95	86	1.45	1.88	28.595%	3.35K	-0.0472
RUT	FEB 20 '14 1020 Put		51	2.10	2.25	135	2.10	2.18	27.691%	5.62K	-0.0554
RUT	FEB 20 '14 1030 Put		55	2.45	2.60	112	2.00	2.53	26.769%	6.62K	-0.0650
RUT	FEB 20 '14 1040 Put		58	2.85	3.00	83	2.85	2.92	25.806%	6.33K	-0.0763
RUT	FEB 20 '14 1050 Put		180	3.30	3.50	32	3.40	3.40	24.983%	7.85K	-0.0909
RUT	FEB 20 '14 1060 Put		18	4.00	4.20	84	4.00	4.10	24.046%	9.98K	-0.1075
RUT	FEB 20 '14 1070 Put		156	4.70	5.00	161	4.90	4.85	23.374%	7.36K	-0.1300
RUT	FEB 20 '14 1080 Put		124	5.60	6.00	174	5.70	5.80	22.298%	7.26K	-0.1527
RUT	FEB 20 '14 1090 Put		86	6.80	7.20	139	6.90	7.00	21.498%	4.17K	-0.1830
RUT	FEB 20 '14 1100 Put		114	8.30	8.70	86	8.40	8.50	20.732%	3.92K	-0.2195
RUT	FEB 20 '14 1170 Call		317	9.50	10.30	151	10.20	9.90	15.411%	3.15K	0.3291
RUT	FEB 20 '14 1180 Call		325	6.10	7.00	158	7.20	6.55	15.008%	3.44K	0.2536
RUT	FEB 20 '14 1190 Call		255	3.80	4.40	139	4.60	4.10	14.416%	2.29K	0.1823
RUT	FEB 20 '14 1200 Call		122	2.25	2.50	62	2.50	2.38	13.748%	3.44K	0.1199
RUT	FEB 20 '14 1210 Call		97	1.20	1.50	117	1.45	1.35	13.494%	7.36K	0.0773
RUT	FEB 20 '14 1220 Call		95	0.60	0.80	147	0.70	0.70	12.945%	8.20K	0.0429

RUT Put and Call Options

Figure
8.1

RUT Put and Call 10-point Spreads



Figure 8.2

Chapter 9

Items to Consider when Making the Trade

As you gain trading experience, the time required for decision making decreases because some decisions (choosing an expiration date, for example) become semi-automatic. The more difficult decisions (adjust vs. exit) require less time because your experience allows the thought process to become more efficient.

When beginning, you may want to consider constructing the iron condor

from a wide variety of options. However, once you go through the process once or twice, you will automatically recognize that many of the calls and puts can be eliminated from consideration. For example, the option's delta, strike price, or premium will be outside the range of acceptable (for you) choices.

Iron condor traders tend to trade far out-of-the-money options, but not so far that the premium is too small to offer much profit potential. Once you trade an iron condor for a specific underlying asset, you will have a good clue as to where to begin the selection process next time.

EXAMPL

**for a 10-
point,
index iron
condor**

Each of us has our own way of thinking and something that may seem obvious to one person may be a mystery to another. So if you have questions, [please ask](#). I hope you will come out of this discussion with a good feeling about your ability to make intelligent choices when building your first (or any) iron condor.

Let's get started by looking at the trading screens ([figures 8.1](#) and [8.2](#)). The data represents a fraction of the available choices (options are available with strike prices ranging from 600 to 1400). Eliminating options that are too far out of the money is one of those easy-to-make decisions.

We must look at the list of available choices and select some worthy of further consideration. For those with virtually no experience, I'll make recommendations. For experienced traders, ignore those suggestions and substitute your own.

*****My
objective is to
help everyone
understand
the selection
process and it
is not to make
specific
recommendations
because***

*market
conditions
change and
our comfort
zones change
along with
them.***

More importantly, sometime it pays to trade more conservatively than at other times. So there is never going to be a single ‘best’ iron condor choice that is suitable for everyone.

First we will look at the numbers and choose a put spread. Next, we’ll look at the call spreads. In this chapter, the commentary is of a general nature

because there is a lot of background that you, the trader, should understand before making trades with real money. The specifics begin in the following chapter.

The data presented in figure 8.1 show put options whose delta ranges from (we ignore the fact that puts have negative delta and only consider the absolute value of the delta) 5 to 22. The call deltas range from 4 to 33.

Fact:

Implied
volatility (IV)
for equity
options
decreases as
the strike price

increases. This is known as volatility skew. Skew was not a factor in options pricing until after the market crash of October 1987. Since that time, market makers took into consideration the fact that markets may decline less often than they rally, but

declines are often much more severe than the rallies. Thus, owning puts (along with a decrease in the number people who are willing to sell puts) became desirable – for protection, if not for speculation. That's just another way of

saying that when the call and put are an equal number of points out of the money, the put options carry a higher implied volatility, and thus are priced higher. And that's the brief story on volatility skew.

Lower implied volatility for call options translates into option prices that say the following: As the market rises, there is a

smaller chance that the underlying price will continue to rise -- and that in turn reduces the probability of the option being in the money when expiration arrives. Therefore, delta (a measure of the probability that an option will be in the money at expiration) is smaller for call options than it is for put options – when the options are equally far out of the money.

What does that mean for us when looking for spreads to trade? It means that call delta and call premium decline faster (compared with puts) as the option becomes farther out of the money. Translation: (a) call premium declines rapidly as we move farther OTM and quickly become too inexpensive to sell;

(b) There may be only two or three viable call options to sell; puts offer a wider selection.

NOTE: Do not become confused by option skew. It is obvious that the underlying asset is a single entity and when estimating its future volatility, there is only one best guess as to just

how volatile
any stock or
index will be.
However,
market
declines tend
to be sharper
and deeper
than rallies and
buyers of put
options are
willing to pay
a higher
premium than
call buyers –
for options that
appear to have
an equal

chance (they are the same number of points OTM) of being in the money by expiration.

Those higher prices translate into a higher implied volatility.

I chose a set of options (figure 8.1) for this conversation because the vast majority of iron condor traders would choose their options from this group.

Looking at the numbers, do not be overwhelmed by how much there is. Some of the numbers can be ignored. The especially important data are:

--The bid and ask quotes for each option (and the midpoint).

Those numbers are important because they dictate the price at which the options can be bought and sold.

--The other very important piece of information is the option delta because it represents a good approximation of the probability that an option will be in the money when expiration arrives. When trading iron condors,

profits are earned when time passes and the options neither move into the money, nor threaten to move into the money.

Therefore low delta options provide a high probability of earning money on the trade. But if the probability (delta) is too

low then the possible profit (premium) becomes too small for you to take the risk of earning that premium.

Traders often ignore the idea that delta can be used as a probability estimate. The primary definition of delta is: An excellent estimate for how much the price of the option changes when the underlying asset changes by one point.

If you are not comfortable selling a spread because the delta of the short option is too high (i.e., the chances of the

option moving into the money make you fear the outcome), that is an important warning sign that cannot be ignored. I've said this before, but here it is again, using different words:

*****Do not own
any position
that makes
you afraid of
potential loss.***

***It is far better
to miss a
profitable
opportunity
than to suffer
anxiety. *****

Traders who are afraid or uncomfortable tend to make bad decisions.

As intelligent investor/traders we do not want trade decisions to be the result of emotional thinking (especially fear or greed). Traders tend to be excited about possible profits, and that may allow greed to take charge of the decision-making process. On the other hand, when the potential loss is high – even when it is unlikely that the amount will be lost -- new traders tend to be overwhelmed with fear. When we construct positions and trade an appropriate number of spreads, then both fear and greed should be absent.

Learning to manage risk goes a long way towards helping you set up trades so that they are comfortable to own. Therefore it is important to think about how to manage risk at the very beginning of your trading career. This discussion is continued in Chapter 17.

The delta of the option being sold goes a long way towards giving the inexperienced trader a sense of how likely he/she is to make money from the position. And once you learn to appreciate the importance of delta, you may realize that for you, delta has become the most important characteristic of the options that you choose to sell.

If you already trade vertical (credit or

debit) spreads, you should already have some experience thinking about delta when selecting your trades. That experience is beneficial to the iron condor trader.

I'll be referring to delta many times during the discussion on making trade decisions using the screen shots in figures 8.1 and 8.2.

Market Neutral

Iron condors begin life as market-neutral positions. That means the trader has neither a bullish nor bearish bias and the trade does not begin to earn or lose money when the underlying asset undergoes a small price change. For that reason, you cannot expect to use iron

condors as your only option strategy, unless you never have a market opinion.

Let's assume that you believe the generally-offered advice of financial professionals: It is next-to impossible to time the stock market well enough to earn extra money and the best results (they say) are achieved by those who buy and hold.

The only portion of that advice of importance to us is the opinion of how difficult it is to know whether the market's next move will be up or down. If you accept that premise, then you will almost certainly want to trade with a market-neutral bias. The iron condor is a suitable strategy for such traders.

The truth is that most individual traders believe that such advice is nonsense and — despite evidence to the contrary. If you are in that group, I recommend using the iron condor only when your market prediction is neutral over the short term.

When you have a strong bullish or bearish expectation, the iron condor is the wrong strategy. Instead, use one half of an iron condor. In other words, you can sell only put spreads when bullish and sell only call spreads when bearish. That means you would be trading credit spreads using calls or puts, but not both. Although there is an obvious similarity between credit spreads and iron condors, there are enough differences that you cannot apply everything in this

book to the credit spread strategy.

What is market neutral?

The traditional definition of a market-neutral spread is one whose total delta is zero or near zero.

Here is a simple set of rules for calculating position delta:

--If you own an option, add its delta to the total.

Remember that puts have negative delta, so if you own puts, subtract the absolute

value of its
delta from the
total.

--If you are
short (i.e.,
sold) any
option, subtract
its delta from
the total.

--For each
different option
in the position
multiply its
delta by the
number of
contracts held.

--The sum is

the position
delta.

Example

This is a bullish position (it has positive delta).

For various (appropriate) reasons, some traders find it more comfortable to own a position that is not delta neutral, but is market neutral from a different perspective.

EXAMPL

**“Neutral”
iron
condor
positions**

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I recommend trading delta-neutral positions when first getting started. However, if you cannot decide which 'neutral' is best for your trading, compromise is possible.

Example:
XYZ is
\$600/shar

The point is that you may choose a 'neutral' iron condor that is neutral by any standard that you care to adopt.

Not quite market neutral

It is possible to trade positions that are 'almost' iron condors, but are

constructed with a small market bias (or market fear). If you want to get fancy with any of those non-neutral positions, please learn how to trade the standard iron condor before trying to outsmart the system.

Example

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It's time to look at the specific options available for trading as we construct our iron condor position.



Chapter 10

The Put Spread

All put options have negative delta. In other words, the price of the put tends to decline as the underlying price rises. All calls have positive delta and tend to gain value when the underlying price rises. Reminder: Sometimes the effects of a substantial implied volatility change can override the effect of delta on the price of any option. Translation: If IV rises by enough, call options could gain value when the stock price falls.

An iron condor is one position with four

legs. However, when deciding which options to include in our position, it is not reasonable to look at all four options simultaneously.

Thus, we choose either the put or call spread first and then the other.

About the numbers

The numbers represent real-world data from Jan 24, 2014. For the purpose of this example, options expire Feb 21, 2014, or 29 days from trade date.

NOTE: In the figures that follow, the options are designated as

expiring Feb
20. Interactive
Brokers (the
source of the
images) uses
that date
because it is
the last day that
these index
options trade.
Settlement for
cash-settled,
Europeans
style RUT
options is
determined by
the opening
prices of each

of the stocks in
the index on
Friday
morning, Feb
21.

Figures 8.1 and 8.2 represent a typical set of live data. For the given expiration date, there are options with many additional strike prices from which you can choose. However, as I will make clear, there is no reason for most of us to care about options that were omitted.

The following text describes how I go about making trade decisions. I've included extra explanatory comments because the idea is to provide insight on how the decision process may work for

you. My objective is to make it less complicated to trade iron condors and to help you weave your way efficiently through the maze of possible positions to find one that is appropriate for you.

One point: Your actual thoughts (real time) will become much more streamlined —once you manage a few trades. If I include too much detail, please understand that it is intended to benefit the less-experienced trader.

Figure 8.1 is reproduced for convenience.

The put sale

Undr...	Description	Nt Pr	Bd Sz	Bid	Ask	Ask	Last	Mid	Implied V. %	OI	Delta
Ac Ac	TIF	Contract	Expiry	Strike	Delta	Gamma	Limit Price	Delta			
Feb 20, 2104 PUTS											
RUT	Index						1148.35			606K	
RUT	FEB 20 '14 1010 Put	53	1.80	1.95	86	1.45	1.88		28.595%	3.35K	-0.0472
RUT	FEB 20 '14 1020 Put	51	2.10	2.25	135	2.10	2.18		27.691%	5.62K	-0.0554
RUT	FEB 20 '14 1030 Put	55	2.45	2.60	112	2.00	2.53		26.769%	6.62K	-0.0650
RUT	FEB 20 '14 1040 Put	58	2.85	3.00	83	2.85	2.92		25.806%	6.33K	-0.0763
RUT	FEB 20 '14 1050 Put	180	3.30	3.50	32	3.40	3.40		24.983%	7.85K	-0.0909
RUT	FEB 20 '14 1060 Put	18	4.00	4.20	84	4.00	4.10		24.046%	9.98K	-0.1075
RUT	FEB 20 '14 1070 Put	156	4.70	5.00	161	4.90	4.85		23.374%	7.36K	-0.1300
RUT	FEB 20 '14 1080 Put	124	5.60	6.00	174	5.70	5.80		22.298%	7.26K	-0.1527
RUT	FEB 20 '14 1090 Put	86	6.80	7.20	139	6.90	7.00		21.498%	4.17K	-0.1830
RUT	FEB 20 '14 1100 Put	114	8.30	8.70	86	8.40	8.50		20.732%	3.92K	-0.2195
RUT	FEB 20 '14 1170 Call	317	9.60	10.30	151	10.20	9.90		15.411%	3.15K	0.3291
RUT	FEB 20 '14 1180 Call	325	6.10	7.00	158	7.20	6.55		15.008%	3.44K	0.2536
RUT	FEB 20 '14 1190 Call	255	3.80	4.40	139	4.60	4.10		14.416%	2.29K	0.1823
RUT	FEB 20 '14 1200 Call	122	2.25	2.50	62	2.50	2.38		13.748%	3.44K	0.1199
RUT	FEB 20 '14 1210 Call	97	1.20	1.50	117	1.45	1.35		13.494%	7.36K	0.0773
RUT	FEB 20 '14 1220 Call	95	0.60	0.80	147	0.70	0.70		12.945%	8.20K	0.0429

**Figure
8.1**

RUT Feb 1020 put

Looking at the choices indicated in figure 8.1, the farthest OTM put that we can sell is the RUT Feb 20 '14 1020 put, and its delta is -.06.

NOTE: If we were to choose to sell the 1010 put, then we would be forced to buy an option not shown in order to complete the spread. Of course, we can do that by adding additional put options to the list of possible options to sell.

Here is the problem: You must draw the cutoff line somewhere, or else there would be far too many options and option spreads to examine. In this example, I chose that cutoff when the delta was less than five. You can select a different range

of options
when making
your own trade
decisions.

Put description RUT Feb 20 '14 put:
This is a put option on RUT, the Russell
2000 Index. The last day that it trades is
Thursday, Feb 20, 2014. The following
morning (commonly referred to as
expiration Friday), the settlement price
is determined. The strike price is 1020.

NOTE: AT
one time all
index options
were settled at
the Friday
morning

opening. More recently, some index options expire when the market closes Friday afternoon. Do not trade any index option until you know when it expires.

Details can be found at the CBOE, or ask your broker. I am not listing the rules for

fear that they
may change
again.

When the put delta is -6, the chances that the option will be in the money when the settlement price of this option is determined (Friday morning, Feb 21, 2014) are approximately 6%. That is true when market conditions remain essentially as they are when that screenshot was taken. If market volatility declines during that time, the chances become even smaller that RUT will be below 1020 at expiration. If market volatility explodes then it becomes much more likely that the option will finish in the money. In other words, in a more volatile environment, OTM options

come with a higher delta (because they finish in the money more often).

NOTE: I have been very careful with the wording in the above paragraph.

There is a subtlety that option traders must understand:

--The delta refers to the probability that the option will

be in the money
when
expiration
arrives. That is
6% in this
example.

--That is a very
different
number from
the probability
that the option
will be in the
money at least
once between
the current time
and expiration.
The latter
probability is

referred to as
the probability
of touching.
“Touching”

occurs when
the underlying
asset touches
the strike price
of either short
option during
the lifetime of
the options.

--Calculators
that measure
the probability
of touching are
available. Ask
your broker, or

try [this one](#).

--To clarify, delta is NOT telling us the chances that the option will remain OTM from the current time through expiration. It only describes the likelihood that an option will be in the money when the option expires.

NOTE:

When using any of the Greeks, the numbers are good approximations but are not meant to be exact.

Therefore it is impractical to use more than one or two significant figures. I use only the first two decimal places and in

this example,
delta is -6.

NOTE:

There is no
standard
agreement as to
whether delta
ranges from
-1.00 to +1.00;
or from -100 to
+100, and you
may choose
either scale. I
prefer
eliminating the
decimal and
refer to the

delta of our example put as being -6, rather than -0.06.

The important points about the delta scale:

--A put whose delta is -100 is expected to move one full point when the underlying asset moves one point.

--A call whose delta is +100 is expected to

move one full point when the underlying asset moves one point.

--At-the-money options have a delta near 50.

--Options have a zero delta when they are so far out of the money that a one-point change in the underlying does not affect

the value of the option.

The put purchase

There is no purpose to be served by analyzing each of the puts when searching for an appropriate option to buy. Once we carefully select which option to sell (the possibility that the underlying asset will trade at or through the strike price of that option represents the true danger point for the position and is the price that we do not want to see the underlying asset approach, let alone penetrate), it is far easier to choose which option to buy. Our preference for a specific spread width is so important, that no other factor is worth considering.

For the following discussion, assume that the spread width (distance between the two call options or the two put options) is 10-points. A more detailed discussion on choosing an appropriate spread width appears in [Chapter 14](#).

If you sell the RUT Feb 20 '14 1020 put, then buying a put that is 10-points farther OTM (RUT Feb 20 '14 1010 put) completes the spread: You would be selling the RUT Feb 20 '14 1010/1020 put spread.

Figure 8.2 repeated for convenience.

Undr...	Description	Nt Pt	Bd Sz	Bid	Ask	Ask	Last	Mid	Ct	Imp'd	Vl. %	OI	Delta
		Ac Ac	TIF	Quantity	Destination	Stts	Lmd Price	Type					
	RUT Index						1148.40					606K	
	RUT FEB 20 '14 - 1010 + 1020 Put			46	0.15	0.28	1	0.25	0.22				
	RUT FEB 20 '14 - 1020 + 1030 Put			72	0.20	0.40	8	0.35	0.30				
	RUT FEB 20 '14 - 1030 + 1040 Put			2	0.35	0.55	5	0.40	0.45				
	RUT FEB 20 '14 - 1040 + 1050 Put			5	0.30	0.50	20	0.47	0.40				
	RUT FEB 20 '14 - 1050 + 1060 Put			151	0.30	0.60	3	0.57	0.45				
	RUT FEB 20 '14 - 1060 + 1070 Put			82	0.50	1.00	15	0.70	0.75				
	RUT FEB 20 '14 - 1070 + 1080 Put			105	0.60	1.00	10	0.70	0.80				
	RUT FEB 20 '14 - 1080 + 1090 Put			166	0.80	1.20	5	1.10	1.00				
	RUT FEB 20 '14 - 1090 + 1100 Put			71	1.10	1.90	74	1.47	1.50				
	RUT FEB 20 '14 + 1170 - 1180 Call			221	2.50	4.00	1	4.00	3.25				
	RUT FEB 20 '14 + 1180 - 1190 Call			184	1.70	3.20	138	3.31	2.45				
	RUT FEB 20 '14 + 1190 - 1200 Call			120	1.30	2.20	176	2.00	1.75				
	RUT FEB 20 '14 + 1200 - 1210 Call			1	0.85	1.15	20	1.00	1.00				
	RUT FEB 20 '14 + 1210 - 1220 Call			20	0.45	0.75	7	0.70	0.60				

**Figure
8.2**

What do we know about this spread?

--I refer to this
as a “6 delta

put spread”
because that is
the delta of the
option sold.

--The market
for this spread
(figure 8.2) is
\$0.15 to \$0.28.

--The wide
market is \$0.15
to \$0.45. We
get these
numbers by
combining the
bid/ask quotes
for the
individual

options from
(figure 8.1):

--Feb 1020
put: \$1.80 to
\$1.95

--Feb 1010
put: \$2.10 to
\$2.25

--Best market
quote is \$0.15
to \$0.45;
making the
midpoint \$0.30

--Notice that
someone is
offering to sell

this spread at \$0.28, or two pennies less than the midpoint of the wide market. That spread seller is far more likely to be a retail trader than one of the market makers because it is below the midpoint—and market makers do not

advertise when they may be willing to sell something at a reduced price.

--At this point, we have not looked at any other spreads for comparison (we do that below), but I estimate the premium that you can collect for this spread to be \$0.25. However, the

only way to
know for sure
is to enter an
order and see
what happens.
You cannot
afford to make
frivolous
trades ‘just to
see what
happens,’ so
the order is
entered only
after you
decide that this
is a trade that
you want to
make.

For my
personal
comfort zone,
this premium
(25-cents) is
too small.
However, if
you are an
inexperienced
trader and want
to own an iron
condor with a
small reward
potential and a
very good
chance of being
profitable, this
put spread

represents a possible trade. Before we can proceed with entering an order, we must do two things:

--Find an appropriate call spread with which to pair the put spread (Chapter 11).

--Continue checking other put spreads

until satisfied
that you found
one well-suited
to your needs.

Back to
choosing the
put to sell

RUT Feb 1030 put

Delta: -7.

The put spread: Feb 1020/1030 put.

Spread quote: \$0.20 to \$0.40.

Wide spread quote: \$0.20 to \$0.50; True
midpoint: \$0.35.

Estimated premium available: \$0.30

Comment: Very similar to 1010/1020 put

spread. Premium is \$0.05 higher and the option is 10 points less far OTM. With RUT trading at \$1148, this spread is 118 points (or 10%) OTM. That is pretty far OTM with 29 trading days remaining.

That option feels as if it is 'safely' out of the money, and the position is well within my comfort zone. But please do not believe that this option cannot become an ITM option. The -7 delta tells us to expect it to be ITM at expiration about one time in 14.

However, the potential reward is 30 cents and this spread is suitable for traders who are willing to accept low profit potential in exchange for a high probability of success.

I often mention 'a high probability of success' for a trade, so let's take a moment to look at the numbers.

The put delta is -7. Assuming we find an appropriate 7-delta call spread, the iron condor position has two short options, each with a 7% probability of being in the money (ITM) when expiration arrives. The probability that either option will be ITM (at expiration) is 14% and for traders who hold all the way to that expiration date, the chance of seeing this spread expire worthless is 86%.

The main problem with expecting to earn the entire premium as your profit 86% of the time is that this percentage ignores

the times when the spread becomes uncomfortable to hold and must be exited (or adjusted) at a loss—before expiration arrives.

For aggressive, risk-taking investors, that can be when strike price of either the short call or short put becomes an at-the-money option. More conservative traders will have quit the trade well before the underlying asset moves that far.

If RUT were to decline as low as 1030 during the lifetime of the options, then the spread would be worth about \$5, or roughly 50% of its maximum value. Sure, the call spread would be virtually worthless at this point, but when we are

short a put spread that costs roughly \$500 to cover (exit), the fact that the call spread can be covered at a very low price is not much of a consolation. [Strong advice: Do cover that call spread when you exit the put spread. Do not take the risk of a market reversal when the potential gain is so small.] When this happens, the iron condor position is significantly underwater (losing money).

We have not talked a lot about risk management yet (see [Chapter 17](#)), but very few traders would consider (correctly, in my opinion) holding an iron condor when one short option is at- or almost at the money. This is not a risk they are willing to take. In fact, most

traders would have given up on this trade before the underlying index fell to this level.

The point of this discussion is that the 86% number does not tell the whole story because for some of those 86 out of 100 trades, you (and I) would almost certainly have covered the position and taken a loss, rather than still be holding until the options expire. Reminder worth repeating: The fact that either of the options will be ITM about 14% of the time at expiration ignores the possibility of the option moving into the money (forcing us to exit with a loss) and then moving OTM by expiration.

The conclusion is that even when the

options are safely OTM at expiration, you will have been forced to exit (with a good-sized loss) some of those 14 out of 100 trades.

The obvious conclusion is that this 14% number may be statistically accurate, but when managing positions, you cannot ignore risk and blindly count on winning 86% of the time.

Traders require additional accuracy concerning probability. Fortunately such numbers are available by using a “probability of touching” calculator that measures the probability that the underlying asset will move to any specific price at any time prior to expiration.

NOTE: You can use any price for the underlying asset; not necessarily the strike price. This can be useful if you want to know the chances that the stock will reach a given price level (if current assumptions — primarily volatility —

remain
unchanged) by
a specific date.

For the newer trader, this is a topic (probability of touching) of lesser importance right now. However it is something worth understanding and a more detailed discussion is presented in [Appendix A](#).

RUT Feb 1040 put

Delta: -8.

The put spread: Feb 1020/1030 put.

Spread quote: \$0.35 to \$0.55.

Wide spread quote: \$0.25 to \$0.55; True midpoint: \$0.40.

Estimated premium available: \$0.35 (available right now because that is the bid, or possibly the true midpoint, \$0.40).

Comment: Once again, this is similar to previous choices. Premium is another \$0.05 higher and the option is another 10 points closer to the underlying market price (1148). This spread is 108 points OTM.

The remaining puts and put spreads

It may seem tedious to look at every put option (and every call option once you are finished with the puts) to find two spreads that, when combined into an iron condor, are best suited to your personal needs. And if you are a new to trading

iron condors (or credit spreads in general), then it is well worth your time to go through a thought process as described above. You do not yet have enough experience to know which options are good alternatives for your situation.

It is tedious. However, this is not a big problem because as time passes (it may only require one or two iron condor trades) and you manage the trades, you should be able to discover where your comfort zone lies and therefore cut the initial list of option spreads to a modest quantity. I will offer some ideas on how to get started with something that is likely to be quite suitable for you right now. Then, as you practice (in a paper-

trading account) managing iron condors by opening a variety of positions and managing each one from entry to exit, you will discover that you are suddenly comfortable enough to begin trading with real money.

NOTE: It is not important to choose the ‘best possible’ iron condor because there is no such thing. Instead there are several ‘very good’ choices

that vary from one trader to another.

When using index options (i.e., SPX, RUT, NDX) there are many possible iron condors from which to choose. You will find more than one that feels right (i.e., good for your trading style). That is good. Do not be afraid to trade because you are unable to decide which is slightly better than the other. A large part of the decision comes with knowing what is comfortable to own because only the individual trader knows what it feels like to have a specific position in his/her portfolio.

When trading iron condors on individual

stocks, the relatively low price of the stock means that there are not as many strike prices from which to choose. Usually one iron condor choice will stand out, but it is possible that you will not be comfortable with any. When that happens, do not force the trade.

NOTE: It is acceptable to trade a 1-lot iron condor as a learning experience.

However, as a long-term strategy, it is important to

own positions
that make you
comfortable.
Perhaps this
point has not
been made
sufficiently
clear:

When you do not like the idea of owning a position at any point in time, my sincere advice is to fix the position (see risk management, [Chapter 17](#)) or exit. The problem with fixing (adjusting) or exiting is that either is likely to reduce profit potential or lock in a loss. As mentioned, having the discipline to take losses is a vital part of the trading game — but traders do not like to take losses.

Thus, it is best to avoid uncomfortable positions because you are less likely to hold onto them long enough for the position to produce a profit.

The 10-point put spreads

Table 10.1
The 10-Point Put Spreads

Strike	Delta	Spread	B/A	Wide B/A	Mid
1020	-6	1010/1020	0.15 / 0.28	0.15 / 0.45	\$0.30
1030	-7	1020/1030	0.20 / 0.40	0.20 / 0.50	\$0.35
1040	-8	1030/1040	0.35 / 0.55	0.25 / 0.55	\$0.40
1050	-9	1040/1050	0.30 / 0.50	0.30 / 0.65	\$0.48
1060	-11	1050/1060	0.30 / 0.60	0.50 / 0.90	\$0.70
1070	-13	1060/1070	0.50 / 1.00	0.50 / 1.00	\$0.75
1080	-15	1070/1080	0.60 / 1.00	0.60 / 1.30	\$0.95
1090	-18	1080/1090	0.80 / 1.20	0.80 / 1.60	\$1.20

Strike = Strike price of option sold

Delta is rounded to nearest whole number

Spread = Strike prices of the two puts that comprise the spread

B/A = Bid and ask quote for *the spread*

Wide B/A = Combined quotes for the individual options in the spread

Mid = Midpoint for Wide B/A quote

The Choice

I would love to provide a formula that you can use to make your selection. The truth is that it is a very personal compromise decision.

--By selling puts that are a little closer to the stock price, the premium (profit potential) increases, but the odds of having a trade that requires no adjustments is reduced.

--By extending

the expiration date (see [Chapter 15](#)), you can collect a higher premium for the put (or call) spread. Or you can elect to earn the same premium by selling options that are farther out of the money. That may add to your comfort. On the negative

side, your capital is tied up in the trade for a longer time AND the longer that you hold the position, the greater the chance that something unfortunate will happen to the index price. Again, it is a compromise.

You must begin somewhere

When a trader goes through the process of deciding which of the several possible put and call spreads to sell, it may seem very difficult to come to a decision. The truth is that it should be difficult because some of the spreads have very similar risk and reward scenarios.

Thus, I offer the following guidance for newer traders. Although it is important to make sound choices, please believe me when I tell you that the decision becomes less difficult as you gain experience managing the trades. You will figure out which positions are safely within your comfort zone.

If you do not know where to begin, try

this:

--Options that expire in two months (8 or 9 weeks).

Alternative: 6 or 7 weeks.

--Spreads that are 10-points wide.

--Selling options whose delta is 7 or 8. However, if you believe that you are a more

aggressive
(and less
conservative)
trader—and if
you are
comfortable
doing so— you
can begin with
delta as high as
9 or 10.

--When you
follow the
suggestions
above, the
premium that
you can collect
is very
dependent on

the current
implied
volatility.

Therefore it is
difficult to
recommend a
minimum
acceptable
premium. But,
do not accept
anything that
you believe is
too small to
justify the risk.

--Trade size:
This is the
most important
decision of all.

Do not lose more than you can afford to lose. The worst-case scenario (large loss) will happen, so be prepared. It is a sound idea to target earning less money while gaining an options education because your primary goal is survival. Once

you learn how
profits and
losses arise,
you can adjust
your trade size
(gently).

Chapter 11

The Call Spread

There are always fewer calls to consider as part of your iron condor than puts. That is a result of the skewed manner that describes how options are priced. In other words, as the options move farther OTM, the premium available from selling call spreads declines rapidly and quickly moves below your minimum acceptable premium.

Undr...	Description	Nt Pk	Bd Sz	Bid	Ask	Ask	Last	Mid	Implied Vol %	OI	Delta
Ac Ac	TIF	Ordering	Commission	Sitz	Limit Price	...	...	...	...	...	...
Feb 20, 2104 PUTS											
RUT	Index						1148.35			606K	
RUT	FEB 20 '14 1010 Put	53	1.80	1.95	86	1.45	1.88	...	28.595%	3.35K	-0.0472
RUT	FEB 20 '14 1020 Put	51	2.10	2.25	135	2.10	2.18	...	27.691%	5.62K	-0.0554
RUT	FEB 20 '14 1030 Put	55	2.45	2.60	112	2.00	2.53	...	26.769%	6.62K	-0.0650
RUT	FEB 20 '14 1040 Put	58	2.85	3.00	83	2.85	2.92	...	25.806%	6.33K	-0.0763
RUT	FEB 20 '14 1050 Put	180	3.30	3.50	32	3.40	3.40	...	24.983%	7.85K	-0.0909
RUT	FEB 20 '14 1060 Put	18	4.00	4.20	84	4.00	4.10	...	24.046%	9.98K	-0.1075
RUT	FEB 20 '14 1070 Put	156	4.70	5.00	161	4.90	4.85	...	23.374%	7.36K	-0.1300
RUT	FEB 20 '14 1080 Put	124	5.60	6.00	174	5.70	5.80	...	22.298%	7.26K	-0.1527
RUT	FEB 20 '14 1090 Put	86	6.80	7.20	139	6.90	7.00	...	21.498%	4.17K	-0.1830
RUT	FEB 20 '14 1100 Put	114	8.30	8.70	86	8.40	8.50	...	20.732%	3.92K	-0.2195
RUT	FEB 20 '14 1170 Call	317	9.50	10.30	151	10.20	9.90	...	15.411%	3.15K	0.3291
RUT	FEB 20 '14 1180 Call	325	6.10	7.00	158	7.20	6.55	...	15.008%	3.44K	0.2536
RUT	FEB 20 '14 1190 Call	255	3.80	4.40	139	4.60	4.10	...	14.416%	2.29K	0.1823
RUT	FEB 20 '14 1200 Call	122	2.25	2.50	62	2.50	2.38	...	13.748%	3.44K	0.1199
RUT	FEB 20 '14 1210 Call	97	1.20	1.50	117	1.45	1.35	...	13.494%	7.36K	0.0773
RUT	FEB 20 '14 1220 Call	95	0.60	0.80	147	0.70	0.70	...	12.945%	8.20K	0.0429

Figure 8.1 repeated for convenience

Figure
8.1

Figure 8.2 repeated for convenience

Undr...	Description	Mk Pr	Bd Sz	Bid	Ask	Ask	Last	Mid	Cl	Impld Vt, %	OI	Delta
		Ac Ac	TIF	Quantity	Destination	Stts	Lmt Price	Type				
RUT	Index						1148.40				606K	
RUT	FEB 20 '14 - 1010 - 1020 Put			46	0.15	0.28	1	0.25	0.22			
RUT	FEB 20 '14 - 1020 - 1030 Put			72	0.20	0.40	8	0.35	0.30			
RUT	FEB 20 '14 - 1030 - 1040 Put			2	0.35	0.55	5	0.40	0.45			
RUT	FEB 20 '14 - 1040 - 1050 Put			5	0.30	0.50	20	0.47	0.40			
RUT	FEB 20 '14 - 1050 - 1060 Put			151	0.30	0.60	3	0.57	0.45			
RUT	FEB 20 '14 - 1060 - 1070 Put			82	0.50	1.00	15	0.70	0.75			
RUT	FEB 20 '14 - 1070 - 1080 Put			105	0.60	1.00	10	0.70	0.80			
RUT	FEB 20 '14 - 1080 - 1090 Put			166	0.80	1.20	5	1.10	1.00			
RUT	FEB 20 '14 - 1090 - 1100 Put			71	1.10	1.90	74	1.47	1.50			
RUT	FEB 20 '14 - 1170 - 1180 Call			221	2.50	4.00	1	4.00	3.25			
RUT	FEB 20 '14 - 1180 - 1190 Call			184	1.70	3.20	138	3.31	2.45			
RUT	FEB 20 '14 - 1190 - 1200 Call			120	1.30	2.20	176	2.00	1.75			
RUT	FEB 20 '14 - 1200 - 1210 Call			1	0.85	1.15	20	1.00	1.00			
RUT	FEB 20 '14 - 1210 - 1220 Call			20	0.45	0.75	7	0.70	0.60			

Figure
8.2

For example (see Figure 8.2 or Tables 10.1 and 11.1)), when we consider the

RUT 1210/1220 call spread (60-points OTM), the premium is \$0.60. Even that premium may be too small for many iron condor traders.

On the other hand, the 60-point OTM put spread (RUT 1080/1090) carries a higher premium (\$1.00). More importantly, put spreads that are even farther out of the money can be sold for a higher premium than the 60-point OTM call spread. In this example, the 80-point OTM put spread generates \$0.75 while the 60-point OTM call spread offers a smaller premium.

The point of mentioning this characteristic of how options are priced is to be sure that you recognize that this

difference exists. Most iron condor traders select positions based on delta (either the iron condor is constructed to be near delta neutral or it is constructed so that the delta of the options sold are nearly equal). I recommend either of those choices. However, if you prefer to trade options that are equally far OTM, then this skewed pricing may produce iron condors that don't feel comfortable to trade.

Table 11.1
The 10-Point Call Spreads

Strike	Delta	Spread	B/A	Wide B/A	Mid
1170	33	1170/1180	2.50/4.00	2.50/4.20	\$3.25
1180	25	1180/1190	1.70/3.20	1.70/3.20	\$2.45
1190	18	1190/1200	1.30/2.20	1.30/2.15	\$1.72
1200	12	1200/1210	0.85/1.15	0.75/1.30	\$1.00
1210	8	1210/1220	0.45 / 0.75	0.40/0.90	\$0.60

Strike = Strike price of option sold

Delta is rounded to nearest whole number

Spread = Strike prices of the two puts that comprise the spread

B/A = Bid and ask quote for the spread

Wide B/A = Combined quotes for the individual options in the spread

Mid = Midpoint for Wide B/A quote

There are two ways to proceed when you have no market bias to consider.

(1) You can go with the put spread that has already been chosen and all you have to do with the calls is find one with

a comparable delta.

(2) Let's assume that you chose the 6-delta put spread (1010/1020). From figure 8.1, you can choose to sell the 1220 call (delta 4) or the 1210 call (delta 8). However, you can make the spread nearer to delta neutral by choosing the 8-delta call spread and choosing a different (i.e., 8-delta) put spread. The 1030/1040 put spread fits the bill.**NOTE:** It is okay to choose put and call spreads with a slightly different delta, but it is NOT okay to choose a different spread width (see [Chapter 14](#)), unless the quantity is adjusted.

If you decide to go with the 8-delta

spreads, your iron condor of choice would be:

RUT Feb 20 '14
1030/1040P//1210/1220C iron condor

The cash credit would be approximately \$0.90 to \$0.95 (midpoint is \$1.00).

Before entering the order, take another look at the final choice. There are questions to answer and some of the background information that offers guidance in making the decisions has not yet been covered. It is presented in later chapters). Are you satisfied with the available credit? Even though the spread is delta neutral, are you comfortable being short options with the specific strike prices chosen? Did you choose a

reasonable quantity of iron condors to trade? Is the expiration date too far away or too near for comfort? Are you sure that you know how your broker's trade entry system works and that you are NOT buying the options you want to sell? If anything doesn't feel right, take your time to come to a final decision: Trade or don't trade. When ready, pull the trigger.

Chapter 12

Choosing the Underlying Asset

When buying equities, everyone understands that a trader must choose the specific stock he wants to own (or sell short). The trader who works with the whole market or a specific segment, can trade a diversified basket of stocks, such as an ETF (exchange-traded fund), mutual fund, or index fund.

The same principle applies when trading options. However, there is one major difference when trading iron condors:

You are not looking for an investment. You are not seeking a stock that will double within a year or two. In fact it is quite the opposite: You want an underlying asset whose price will hold relatively steady over the lifetime of your option position.

NOTE: Do not plan on constructing an iron condor on a dead-in-the-water, very non-volatile stock because the premium on those options is

tiny.

Because I cannot offer guidance on how you should pick the stocks that are right for you to trade, I'll offer one suggestion. Unless you have a reason to trade a specific stock, the iron condor strategy works best with broad-based indexes. The single most important reason why that is true is that a large collection of stocks is not subject to a wild price swing based on unexpected company-specific news. Because iron condor traders lose money when the underlying undergoes a large price change, it is less risky to own an iron condor position on an index or ETF when compared with an iron condor on a single stock.

It is better (but not mandatory) to trade options that others are trading—options with a significant trading volume where the markets are liquid. For that reason, I recommend the following broad-based indexes/ETFs for iron condor traders:

--SPX (index)
or SPY (ETF)
that tracks the
S&P 500
Index.

--RUT (index)
or IWM (ETF)
that tracks the
Russell 2000
Index.

--NDX (index)

or QQQ (ETF)
that tracks the
NASDAQ 100
Index.

If you prefer to trade a more narrow index perhaps — one with stocks in a single industry, or mid-cap stocks, please have some reason for believing that sector will trade in a narrow range and not be more volatile than the rest of the market.

Chapter 13

Choosing Strike Prices

By now I hope that you appreciate that some compromise is necessary when selecting strike prices for the options that comprise your iron condor position.

There are several considerations in play simultaneously, and the best trade for you has to satisfy all of the following. The trader:

--Wants to own the position. It is not supposed to be a

borderline
decision. It is
better to pass
over a trade
rather than
accept
something that
you believe is
mediocre.

There will be
plenty of other
opportunities.

--Knows in
advance

--The
maximum
attainable

profit.

--The target profit when planning to exit prior to expiration.

--The maximum theoretical loss per 1-lot iron condor. This is the most important decision because it helps determine

position size.

--The maximum acceptable loss when managing the trade. This should be significantly less than “the maximum theoretical loss.”

--Is comfortable accepting the risk in an attempt to earn

the target
profit.

--Is
comfortable
knowing that a
significant
market rally or
decline is
likely to result
in a loss.

To satisfy each of these conditions, you must make a decision regarding the following: expiration date, delta of the options to be sold, spread width, the cash value collected upfront, and whether to be delta neutral or to enter

the trade with a small market bias.

Because there are several factors to you consider, it is impossible to tell you where you will be most comfortable. However, the idea of choosing an appropriate option is described in detail throughout the book, and you should be able to find a suitable iron condor trade at any time that you believe it is the correct strategy to adopt.

For my trading, I prefer to begin with equal delta (for the options sold) and construct the iron condor from that. That may not be the best choice for everyone. Warning: Market conditions change and an appropriate delta today may be inappropriate in the future. It may seem

trite, but the best way to know whether the iron condor that you decide to trade is appropriate is to examine your gut feeling. If the thought of owning this position makes you uncomfortable, then it is a poor choice.

Chapter 14

Choosing the Spread Width

At first glance it seems to make little difference which specific spread is chosen, as long as you are very careful when selecting the specific options to sell. However, it makes a large difference.

For example, when deciding to build the iron condor by selling the RUT Feb 1020 put, you could buy the RUT Feb 1010 put, thereby selling the RUT Feb 1010/1020 put spread.

However, if a trader does not recognize

the risk involved, it is easy to decide to sell a spread that is 20-points wide (1000/1020P spread), or even 30-points wide (990/1020P spread).

I recommend that you begin by choosing 10-point spreads when your underlying asset is one of the broad based indexes. More on this below.

IMPORTANT NOTE:

When trading an individual stock, especially low-priced stocks, 10-

point spreads
are not likely
to be feasible.
You should be
more
comfortable
choosing 5-
point spreads,
2 1/2 -point
spreads, or 1-
point spreads,
when such
choices are
available.

****NOTE:**

When trading

*ETFs, such as
SPY, it is
crucial NOT
to trade 10-
point spreads.
Those are far
too wide.
Please
understand
that a 1-point
SPY spread is
very similar to
a 10-point
SPX trade
because the
asset price is
1/10 as large*

*(\$190 vs.
\$1,900). Thus,
1-point is the
recommended
spread width
for SPY, IWM,
QQQ and
similar
exchange
traded funds.

However, 10-point spreads are not for everyone. There can be very good reasons for selling wider call and put spreads, or even the narrower 5-point spreads. For example, if you sell the RUT Feb 1010/1030 put spread

--The premium collected is larger (almost double).

-- The potential profit is larger.

--THE
MONEY AT
RISK IS
TWICE AS
LARGE

IMPORTA

NOTE: It is essential to recognize that money at risk

doubles when trading 20-point spreads instead of 10-point spreads. Thus, it is mandatory to trade only one-half as many iron condors when the spread width doubles.

Similarly, trade only one-third as many spreads when the width

triples.

Do not fall into the trap of believing that risk has not really doubled because the underlying has to decline further before you can lose the maximum theoretical amount. Proper risk management requires that you avoid being exposed to a loss that is too large to handle comfortably.

One reason that traders prefer the 20-point spread is to save money on commissions. This seems to be an obvious thing to do. Instead of trading 6-lots of a 10-point iron condors, the trader enters an order to trade only 3-lots of a 20-point spread. Risk and reward for the

3-lot and the 6-lot trades are similar. However, commissions are reduced. That seems to be a good thing. However, please be aware of a trap that I want you to avoid. The following discussion is presented at the beginner level to be certain that every reader understands the subtleties.

Two 10-point iron condors vs. one 20-point iron condor

Compare two positions:

Position A:

Sell 2 RUT Feb 20 '14 1090 puts

Buy 2 RUT Feb 20 '14 1080 puts

Credit: \$110 per spread; \$220 total credit

Maximum possible profit: \$220

Maximum possible loss: \$1,780 (\$890 per iron condor)

Position B:

Sell 1 RUT Feb 20 '14 1090 put

Buy 1 RUT Feb 20 '14 1070 put

Credit: \$205

Maximum possible profit: \$205

Maximum possible loss: \$1,795

The numbers are similar, but not exactly the same. Let's see why this is true.

Equivalent position

Let's consider buying two different 10-point spreads. This is merely an example, and you would never enter the following two orders:

Sell 1 RUT Feb 20 '14 1090 put

Buy 1 RUT Feb 20 '14 1080 put

Sell 1 RUT Feb 20 '14 1080 put

Buy 1 RUT Feb 20 '14 1070 put

When you mentally make both trades, the 1080s cancel and you are left with a position that is short the 20-point, 1070/1090 put spread. This is universally true when the two 10-point spreads have one strike in common.

NOTE: If you prefer to trade the 20-point spread, do it in one transaction.

Enter an order
for the wider
spread and
never trade
both spreads
because it
would be a
significant
waste of
money. [Extra
commissions
plus buying and
selling the
option with the
common strike
price (1080, in
this example)
costs money in

slippage.]

Choosing spread width

Here is the lesson in a nutshell. When considering which 10-point spread to trade, it is very often true that you will find a single spread that most closely fits your objectives for the trade. When that is true, it makes sense to make that trade. In the above example, when you compare the 1080/1090 and the 1070/1080 put spreads, you will discover some obvious differences:

--The
1080/1090 put
spread is
closer to the
money and you

can collect a slightly higher premium.

--The 1070/1080 spread is farther out of the money and there is a slightly smaller chance that RUT will decline far enough to cause problems.

--The 1090 put

has a -18 delta
and the
1080/1090 put
spread is
expected to be
(at least
partially) ITM
at expiration
about 18% of
the time. The
1080P has a
-15 delta and
the
1070/1080P
spread will be
in the money
(at expiration)
about 15% of

the time.

--Notice that these differences are real enough that most traders can reach a decision and choose between them.

Trading RULE: Choose the narrower spread when possible, as long as you truly prefer that specific position. If you like both equally, then that is the time to trade the wider spread—and that gives you the same position as trading an

equal number of each of the more narrow spreads. If you have a real preference, do not trade the wider spread just to save a few dollars on commissions. Instead trade the spread that you prefer to own.

There is a totally different school of thought for traders who want to be short strangles (short put and short call). I cannot recommend this strategy to anyone, but it should only be adopted by very experienced traders who are willing to take the risk of being naked short options.

They believe that buying options to complete the iron condor is a waste of money. They may choose the iron condor

trade for the sole purpose of reducing margin requirements. This group is not concerned with risk (a poor decision) and tends to trade very wide (50- or even 100-point) spreads because they have to buy something to get that margin reduction, and they want to spend as little cash as possible. This is something that I discourage.

I hope you appreciate the importance of spread width. It is not merely an afterthought. It is an important part of the decision-making process because it establishes your maximum possible loss for the trade. The primary consideration remains choosing which put (and call) to sell, but choosing the proper spread width is not to be ignored.

Chapter 15

Choosing the Expiration

Expiration Style

Options are either American style or European style and the description has nothing to do with where the options are traded.

American style options may be exercised by their owners at any time before the options expire. Upon exercise, 100 shares of the underlying stock are ‘traded.’

--Call owners
buy stock from

call sellers.

--Put owners
sell stock to
put sellers.

--All
transactions
occur at the
strike price.

NOTE: For
inexperienced
traders: If you
buy (cover) an
option sold
earlier, you no
longer have to
be concerned

with the
exercise/assignment
process.

European style options may be exercised only at expiration. Thus, there is no such thing as ‘early exercise’ of this option type.

These options are cash settled. When expiration arrives, all owners of an in-the-money option receive, in cash, the intrinsic value of the option. The cash is transferred from the accounts of traders who sold (and did not cover) those options. At-the-money and out-of-the-money options expire worthless. This is very convenient because no shares change hands.

The major index options (except for OEX) are European style and that is another reason why they are appropriate options for iron condor traders[Early exercise could become a serious risk issue if you unexpectedly had to buy via assignment) an ITM option – because you would have had no chance to balance your position before the market opens.]

Expiration date

When it comes to picking the expiration date, much depends on the individual trader. Long-term iron condors are inappropriate for the vast majority of traders and I recommend not using options with expiration longer than four months, unless there is some special

situation.

Very short-term (weekly) iron condors

The indexes that I recommended for iron condor trading—along with ~300 of the more actively-traded stocks—have listed options that expire every week. These options are very much of a good news/bad news story. Time decay is rapid and when trading these very short-term iron condors, you will love the rate at which you can make money.

On the other hand, these options cannot be very far out of the money at the time they are sold (because time is so short that they would be essentially worthless), and that means any decent-sized rally or decline quickly places

these spreads at risk of losing money.

It is the Greek 'gamma' that allows us to measure this risk. [Reminder; gamma is the rate at which an options delta changes when the underlying moves one point. It is those rapidly changing deltas that make an option appear to have limited value one minute and considerable value the next.]

The bottom line is that these weekly iron condors are for traders who want more action. That means higher reward for greater risk.

My opinion: These are not for newer traders. Get some iron condor risk management experience before tackling these. Wait until after some of your

trades have gone awry and require that you make a decision regarding risk. When you open a position and exit with no problems, that does not count towards risk-management experience.

For traders who prefer to work with short-term options, I find it is better to trade these options with a directional bias. Thus, I use the single credit spread, rather than the iron condor when I want to be bullish or bearish for a few days. When truly market neutral, I prefer iron condors with lifetimes that range from one to three months.

Moderately short-term (30-day) iron condors

Unless you want to trade very-short term

options, these are the most often selected expiration dates for traditional iron condor traders.

The major tradeoff is as it is with all iron condors:

- The fewer the number of days before expiration, the faster the time decay,

- More time allows you to sell farther OTM options and still collect a good

premium.

My opinion:
Begin with a 2-month iron condor and see how you feel about the trade as it progresses.

Newer traders should sell options with a delta of 7 to 8 while experienced traders can choose something

appropriate for
themselves
based on that
experience.

If you are
impatient with
the 2-month
position (after
giving it a
trial), try a
shorter
expiration time
frame for your
next trade. If
you like being
short options
that are farther
out of the

money and if
that makes you
feel
comfortable,
you may want
to try a 3-
month
expiration for
your next trade.

--For the
conservative
trader, my
favorite iron
condor
involves index
options that
expire in 12-
or 13-weeks.

The options sold have a delta of ~ 15 and the spread width is 10-points. I require a premium near \$3.00 (\$2.75 to \$3.30). In today's (mid-2014) market environment, implied volatility is very low (VIX=11) and it is impossible

to generate
such high
premium.

--3-month
options are
rich in vega
(another of the
Greeks that
measures the
sensitivity of
an option's
premium to a
change in the
implied
volatility (IV)).
For that reason,
it makes sense
to sell 3-month

options only when IV is already above average. Why? Because if you are short vega (and all iron condors are short vega) as implied volatility increases, the spreads that you sold will increase in value. The market may not move much and

your position
may look quite
safe, but the
higher IV
means that
money has
been lost and
you would
have to hold
for a longer
time than
originally
anticipated to
earn the
desired profit.
The longer the
position is
held, the more

time there is
for something
to go wrong.
Thus:

Bottom line: Do not sell 3-month (or longer-term) iron condors unless IV is high enough to provide a \$3 premium on the 3-month, 15-delta iron condor.*

*Definition: A 15-delta iron condor is one in which the call and put options that you sell each have an approximate delta of 15. The spread width does not affect the definition.

--If market
conditions are

not right for a 3-month iron condor, then I suggest durations of 6 to 8 weeks for conservative traders.

--The one-month iron condor was (by far) the most popular iron condor before weekly expiration dates became available. It is

still a good
compromise
position for
those who want
more rapid
time decay but
who do not
want the added
risk that comes
with the extra
negative
gamma
associated with
weekly
options.

Long-term iron condors

I do not recommend iron condors with
lifetimes longer than 4-months. LEAPS

options do exist and you can collect a nice premium for a 2-year LEAPS iron condor. However, time decay is very slow and who knows where the market will be in one year, let alone two? Iron condor traders earn money from time decay and there is little reason to tie up your cash to meet margin requirements) for such a long time.

Chapter 16

Deciding when to Exit

Traders face three decisions every day for each position in their portfolios:

--Do nothing
and hold.

--Adjust or
modify the
position.

(More on this
in Chapter 17.)

One possible
modification is
to close a

portion of the
position, or
using the
language of
traders, reduce
position size.

--Exit.

By far, the most common decision is to hold and await developments. In other words, once you own an iron condor position, most days you will discover that the position is safely within your comfort zone and that there is no reason to take any action.

However, it is important to recognize that deciding to hold is as much of a decision as any other. It is easy to get

into the (bad) habit of holding the trade for ‘just one more day’ to see what happens. I encourage you to take time each day:

*****Examine
each position.***

***Decide: Do
you like this
position well
enough to
hold?***

***Has the
position
become too
risky?***

*Would it be
beneficial to
adjust or exit?*

*Should you
consider an
exit because
the position
earned its
target profit?*

Much of the time, it will be obvious that you want to hold. But getting into the habit of examining what you own can only improve your results. Complacency is the enemy of a profitable trader.

Because the iron condor earns money as

time passes (and nothing unpleasant happens to the stock or index price), holding is a painless decision and an easy one to make.

However, there will be times when holding doesn't feel right. I must caution you not to hold positions for the sole reason that you do not know what to do. A true novice has a good excuse for not knowing which specific risk-management action to take, and may be hesitant to act. That is one good rationale for using a paper-trading account to gain risk-management experience. The more experienced trader should be able to make a sound "hold or adjust" decision. When you are not confident about such a decision, then

my advice is to compromise by closing part of the position to reduce size.

NOTE: That does not mean buying back your short options. That is not closing “part of the position”.

However, it does mean buying back one- or more lots of the call or put spread that is in

trouble. If your trade consists of only one-lot, then this choice is unavailable.

Sometimes by looking at the risk graph provided by your broker you may discover all the clues needed to make a good decision. When you see how much money can be lost if certain events happen (the stock price moves 1, 2, or 3%, or if some days pass, or if IV increases), you will know whether such events will leave you in good shape or whether defensive action is necessary. For example, if your loss is small (by your standards) when the stock price changes by 2% today, then you should

not panic when the price does change by that 2%.

What you want to do is take another look at the risk graph and determine the stock price at which you would no longer be comfortable owning the position. By the way: If you do this risk graph study at the time the trade is initiated, you can devise a trade plan that covers several “what if” scenarios. When you have a trade plan, it becomes much easier to manage the trade on a day-to-day basis because some “adjust now” decisions have already been made.

If you find yourself in the position of not really knowing whether your comfort zone boundaries have been breached,

you are probably best off holding for another day (or hour or however often you can re-examine the position). Why? Because newer traders tend to panic by adjusting too soon and it is less common for them to panic by refusing to take action.

Keep in mind that any trader can (and should) be afraid of potential losses, and that is the reason for writing a trade plan. By making decisions in advance, you will not have to make such decisions in the heat of battle. For example, when the maximum acceptable loss has occurred, then it is exit time. It is not the time to think about alternatives.

The experienced trader can make a more

detailed decision. He/she should have some experience with adjustment methods and that makes it much easier to decide whether one of those methods ([Chapter 19](#)) is appropriate at this time.

But the basic advice still applies. If you do not want to hold the position, do not own it. If you are truly undecided as to what action to take, exiting one-half the position becomes a decent compromise.

Exit; Covering the position

You can adopt one of three basic plans when exiting:

--Exit only
when
expiration

arrives and
allow the chips
to fall where
they may. (This
is a bad
strategy.)

--Exit any time
that you are
satisfied with
the profit.

--Exit at any
time that the
position
becomes too
uncomfortable
to hold.

As an intelligent trader, you must be flexible and allow your judgment to play an important role in all decisions. Yet, the three basic choices above cover the gamut of possibilities. Let's examine each, looking for flaws.

1. Hold to expiration

In my opinion this is the worst possible choice. Yet it is fairly common among unsophisticated traders. It is acceptable to decide to hold to the end for any given trade (for the right reasons), but it should not be a basic part of your general strategy.

The argument goes something like this: When the trade was made, you knew the

maximum possible loss, and that loss must have been acceptable (even if undesirable). If it was acceptable then, it should be acceptable now. Hold the position and let luck play a big role in your results.

If you believe that you have some skill when trading (why are you willing to risk money if you do not believe you have such skill?) or are currently learning the necessary skills, then do not allow luck to play such a large role in your results. Only traders who lack such skill or who don't understand what they are doing should depend on luck. Just know that doing so is gambling, not investing and certainly not trading.

Luck always plays a big part in our trading profits. Trading iron condors is a statistical game—and we know the probability of success/failure. When we make an 80% play we expect to win 80% of the time. However, we cannot allow any of those losses, which occur 20% of the time, to wipe out the profits from the winning trades. For that reason, it pays to manage the position and not to hold all the way to expiration. In other words, when we are in one of those losing trades, we can cut losses and do not have to risk taking the maximum theoretical loss on the trade.

Clarification: The maximum acceptable loss (this is far less than the maximum theoretical loss) that you wrote into your

trade plan is just that: a maximum. Sound risk management techniques should prevent your losses from reaching that point too often.

Looking back on your trades, if your profit/loss ratio is close to 100%, then recognize that you had a bit of good luck. If your ratio is near 50%, then things did not go your way often enough.

You cannot change good or bad luck, but you can make good decisions that move the odds of achieving a winning trade further in your favor. When your profit/loss ratio is exceptionally high or low, it is important to study the results and determine the role that luck played in your results. If you never adjust and

always hold to expiration, then your results are going to be based on luck. If you are not making sound risk-management decisions, then you cannot expect to find success.

If you must hold; if you must seek the maximum possible profit; then please recognize that profits can disappear quickly when expiration nears. Using the language of traders, keep your position size small.

Remember this: Once you are earning money from any position, that profit represents your money. Do not take extra risk with that money thinking that it belongs to “the house”.

2. Exit when happy

What can one say against this philosophy? If you get out of the position any time that

--The profit stated in the trade plan has been earned.

--You have so little possible profit remaining that it does not pay to risk an adverse market move to earn that small sum.

Example

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3. Exit when uncomfortable

--Traders who can pull the trigger on this decision are those who will become successful. You have so many opportunities to make new trades that it makes no sense to own any position that makes you

uncomfortable.

--You changed your mind and currently believe that the market is very likely to be more volatile in the very near future. You may not be 'happy' with the current profit/loss picture, but this is a position that should be closed or adjusted.

--The position is far from neutral because the underlying index has undergone a decent-sized price change. If the market continues in that direction for another day, your loss (as estimated by using risk charts and the Greeks) will be more than

you can
tolerate. This
position is too
risky and you
should not
want to own it
any longer. It
may be
tempting to
hold for just
one more (one
more day, hour,
minute, or ??),
but do not fall
into that trap.
This is where
good discipline
proves

valuable.

--You earned nearly all the available profit and are afraid that it could disappear. This decision may be motivated by fear, but that is acceptable for traders with a bit of experience.

The novice is likely to be fearful of too many different

situations and
that is why
small position
size is
essential (it
helps reduce
fear).

--Do allow
fear of taking a
big loss help
you get out of
positions with
too little
remaining
reward
potential. A
common
example of this

occurs when
expiration
week arrives
and the iron
condor can be
covered by
paying \$0.05
for the call
spread and
\$0.05 for the
put spread.
Each spread
may seem to be
safely out of
the money, but
for a small
sum, all risk
(and fear) can

be eliminated.
This is an ideal
time to exit, if
you haven't
done so earlier.

--Almost
anything can
cause a trader
to be overly
concerned with
a specific
position.

Perhaps a
major news
announcement
is due in one or
two days and
you fear how

the market will react. There is nothing wrong with exiting now, just for the peace of mind that it brings.

It is always acceptable to close your position and exit. It is not always the decision that leads to the best result because an adjustment may improve the risk/reward characteristics of the position, but it is always a reasonable choice. In addition, you must understand how risk-reducing trades work before applying them.

That's next.

Part III

Managing Risk

Chapter 17

Basic Risk Management

There are two basic ways to invest:

- Invest your cash and hold forever.

- Constantly reevaluate your holding and make changes when necessary.

I am not Warren Buffett, whose preferred

holding period is forever. Nor can I discover the outstanding investment opportunities for the future. I recommend that investors periodically examine every investment and decide whether it still belongs in your portfolio. If yes, and if the price has appreciated so that this holding is larger than the average holding, sell a portion to balance the portfolio. Next, use the cash for another investment, or re-allocate the funds to something other than equities.

Very long-term investors can work on their holdings once or twice every year, and that should suffice. If you write covered calls, then checking the status of each position every couple of weeks probably serves your purpose.

But iron condor traders are not for investors. They are used strictly as a shorter-term trading strategy. As such, I encourage you to examine each position every day. Why? Because at some point in time, it is very likely that you will no longer want to hold the position as it currently exists. That happens:

--When the position reaches its target profit.

--When the remaining gain is too small to be worth any risk.

--When IV surges or when the underlying asset price changes, money has been lost. The probability of losing an additional sum has increased to an unacceptable level.

Real vs. ‘Paper’ Loss

Let's assume that you make a trade and collect (for example) \$200 per iron condor. A few days pass and the market rallies by 3%. If you want to get out of

the position, it would cost \$250 per iron condor.

Most people like to think of this as ‘only a paper loss.’ If they continue to hold they “know” that they have a good chance to recover that loss and eventually earn a profit on the trade.

It is true that they have a good chance to recover and profit. However, the loss is real (but unrealized). What is not true is that ‘it is only a paper loss.’ This is not the place for a discussion about the philosophy of trading, but I want you to understand that this is a real monetary loss.

When you look at this position, you have two choices.

--Exit and
accept the \$50
loss.

--Hold and
await
developments.

There is nothing wrong with holding and, in fact, although we are not looking at the specifics of this trade, it is very likely that almost every trader would elect to hold because this position is not very different from the starting position (delta of short options is not much higher).

However, the one reason for holding that is unacceptable is: refusing to take a loss. If I do hold, it must be because:

--I like the position at its current \$250 price and would prefer to hold rather than exit.

--I am comfortable with the position. That means:

--The delta of the short options is not too high for my comfort zone.

--The number of points (or percentage of the underlying asset price) that my short options are out of the money is not a concern.

--Imminent risk has not increased beyond my comfort level. (More on this below).

--The dollars

lost is less than
the limit
mentioned in
my trade plan.

Imminent Risk

When you make a trade for which a change in the underlying price results in a loss — and the iron condor is such a position — then you should have an idea of how much further the underlying price can change today before you become nervous about further losses. In other words, if short RUT 1150 calls, your trade plan should include a price at which you would seriously consider taking defensive action. That price point depends on many factors and I cannot offer specific guidance that suits every

reader. However, by using risk graphs, you should be able to figure out a price level (or a delta level for the 1150 calls) that makes you uncomfortable.

Example

The point of this discussion is to offer one more idea for the thinking trader. It may seem trivial, yet it is seldom discussed. Let's call it a very strong suggestion, rather than a rule:

*****Do not
initiate an
iron condor
position when
it is highly
likely that it
will move***

*outside your
comfort zone
before your
planned
profitable exit.*

*This
minimizes the
need for
making
adjustments.*

Gamma

As time passes and as expiration nears, two things change for the iron condor position: Profits accumulate when the underlying asset behaves; and negative

gamma increases. The reason you are concerned with that negative gamma is that the option delta can change very quickly when gamma is high and a “safely-out-of-the-money option” can quickly move into the money. That results in a significant loss (the loss is more severe when little time remains before expiration arrives).

The different iron condor types

[Earlier](#), I mentioned four different types of iron condor—and the fact that each should be managed differently. Below is a very brief discussion:

1. **Far OTM iron condors** generate little premium, but the probability of earning a

profit is high. The difficulty with owning this position type is knowing when to cut losses and exit. For example, looking at a 10-point iron condor for which the premium was \$0.25, no one would want to suffer the maximum loss of \$9.75, but discovering a comfortable time to exit is difficult.

If you are the type of person who exits early and often – to insure that nothing terrible happens — then you will have too many losing trades. If this FOTM IC strategy does not result in a winning trade at least 90% of the time, then (from my perspective) your overall profits will be too small and this strategy will not be viable. If you earn the full \$0.25 nine times in 10, then the one loss must

be less than \$2.25 for you to break even – let alone earn a profit. If you take that loss when the price reaches \$1.00, then you may be exiting more often than one time per 10 trades. It is truly a management quandary.

If you never adjust, refusing to take any loss, every once in a while the position can lose enough money to cancel 2- or 3-years' worth of profits (assuming one trade every month). That is not viable either.

This strategy presents a true dilemma and I urge you not to trade cheap iron condors. I cannot tell you what represents a minimum premium for your trading style. If you are new to the iron-

condor game, then I suggest a reasonable place to start is not accepting less than \$0.55 for a 1-week iron condor or \$1.00 for a 4-week position.

2. Trading CTM (close to the money) iron condors requires a very different mindset. First, the options sold have a higher delta than your standard iron condor (that is part of the definition of a CTM position), and the options may be close enough to being ATM that the trader wants to make an adjustment because the position is uncomfortable to own.

If that is how you feel, then do not trade this iron condor type. It makes no sense to own positions that are uncomfortable

to hold. However, if you understand the rationale for owning CTM positions, then it should be very comfortable to see why there is nothing scary about trading CTM condors.

Rationale for this (CTM) IC type:

--The premium is high (perhaps \$3.50 to \$4.50 for a 10-point iron condor).

Therefore, the maximum possible loss is less for this trade than for

other iron
condor trades.
Although you
will have
fewer trades
that work
perfectly —
i.e., you get to
cover at your
desired profit
level with zero
adjustments —
but those few
trades produce
very high
profits.

--If the
underlying

asset
undergoes a
price change
and one of the
short option is
at the money,
or almost at the
money (delta
between 40
and 50), it
becomes time
to adjust the
position to
reduce risk.
The
recommended
adjustment is
the roll down.

Translation:
cover the ATM
spread and sell
an equal
quantity of
another spread
of the same
type (i.e., if
you covered a
call spread,
sell a new call
spread; if you
covered a put
spread, sell
another put
spread), such
that the spread
sold expires at

the same time and is farther out of the money. The cost depends on implied volatility and costs less when IV is high.

--The roll down will cost \$200 to \$300, depending on how you choose the strike price of the new spread,

implied
volatility, and
the number of
days that
remain before
the options
expire.

However, the
cost to roll is
almost always
going to be
significantly
less than the
original
premium
collected. In
other words,
you own a new

iron condor
and your
remaining cash
premium is no
longer high, but
is high enough
for you to be
able to come
out of the trade
with a decent
profit – as long
as another
adjustment is
not necessary.
And that is
pretty much
standard
operating

procedure for
iron condor
traders: One
adjustment
leaves room
for a profitable
trade, but most
of the time that
a 2nd
adjustment is
necessary, the
profit (if any)
will be small
and a loss is
likely.

--Once the
position has
been rolled

down, the iron condor is not going to be very different from the traditional iron condor

(described in the next bullet point), The option spreads will be far enough out of the money that you have a decent chance to earn a profit.

--This is the

mindset that
has to be
understood for
you to be
comfortable
trading CTM
iron condors:
Think of this
newly adjusted
position as
being quite
similar to one
that you might
have chosen
for your
original iron
condor
position. True,

the residual premium will be a bit less than you could have collected for this position earlier, but in return, you had a chance (if no adjustment had been needed) to exit with a very good profit. So, if you have a position similar to a

more
traditional iron
condor and if
the premium is
not hugely
different, then
holding the
CTM iron
condor caused
no harm and
you were able
to handle the
risk
management
decisions
appropriately.

--One other
benefit of

trading CTM
iron condors.
Because the
premium is
high, you can
afford to trade
smaller size
and have even
less money at
risk per trade.

3. Very short-term (one- or two-week) iron condors. There is a reason why options that expire weekly have become very popular among individual investors. For option buyers, the premium is lower and a big, quick stock price change can provide large profits. For option sellers, time decay is very

rapid and profits can be earned quickly.

Warning: These are tricky to trade and require the talents of an experienced iron condor trader. In the previous sentence, the term “experienced” refers to someone who has successfully handled decisions involving when and how to adjust positions. It does not refer to a trader who has opened and closed several iron condors without having to face difficult risk-management decisions.

The obvious rationale for owning a one-week iron condor is that you can earn a very nice profit in ~ 3 days (I encourage exiting no later than Thursday afternoon when the options settle at Friday's

opening prices). The problem is that the premium is small and the iron condor options are not very far out of the money. Deciding whether to hold another day to collect the time decay comes with taking the risk of a rapidly-increasing loss when the stock price is moving. This is a difficult situation for inexperienced risk managers. It is easier to gain useful experience by trading the traditional iron condor (below).

4. Traditional iron condors. It is impossible to define a “best” iron condor to trade because the first requirement is that the position must be comfortable to own — and each of us has a different idea as to what is comfortable.

Thus, by my definition, the traditional iron condor is the position you prefer to trade when you DO NOT want to own “something different.” In other words, you would not be choosing an iron condor that fits into one of the three previous categories.

A few years ago when IV was higher, my traditional iron condor was a 13-week, 13- to 15-delta, 10-point RUT iron condor with a premium of $\$3.00 \pm \0.30 . In today's low IV world, it is impossible to achieve a premium anywhere near that level. Thus, do not expect to select a favorite iron condor type and trade it forever. Market conditions change and you must accept that fact. In more recent times, I chose to

trade shorter-term (one to four-week expirations), rather than trade 13-week positions with a reduced premium. Experiment and find something suitable for your needs. Being comfortable is important. Please do not force a trade when you do not truly want to make that specific trade.

The most important aspect of risk management is to recognize when it is necessary to change the risk characteristics of your position. It is not a good idea to initiate a position and let the chips fall where they may. The idea behind proper risk management is to take your profits when they are available and to minimize—when appropriate—the possibility of suffering a large loss.

Chapter 18

Advanced Risk Management: The Concept

If you decide to make an adjustment (other than reducing size or exiting) to an existing position, then there are numerous possible adjustments. In the next chapter we will examine a few specific examples. But first, more discussion is necessary.

An adjustment trade serves one purpose: It reduces risk.

--Sometimes
the probability

of losing
money (from
the adjustment
point into the
future) is
lowered.

--At other
times the
adjustment is a
reduction in the
total cash at
risk (i.e., the
maximum
possible loss).

*****An
adjustment is
not a***

*desperate
attempt to
take a trade
that has lost
money and
magically turn
it into a
profitable
trade. ***

The philosophy of adjusting positions

An adjustment should not be made just because you refuse to accept the fact that the current position has lost money.

It is far more intelligent to unload (exit) a bad position and buy a new position, one that you believe has a much better

chance to earn a profit – from the time that the position was adjusted into the future -- and not counting from the time that the original trade was made.

It is important to understand why adjustments are made. This may seem trivial, but too many traders ‘adjust’ risky positions with the hope that all will turn out well in the end. That is not trading. That is not adjusting. That is gambling.

*****The
adjustment is
made to
protect the
assets in your***

*account and
generate
future
earnings. It is
not made to
recover past
losses. ***

An adjustment should not be made just because you refuse to accept the fact that the current position has lost money. It is far more intelligent to unload (exit) a bad position and buy a new position that you believe has a much better chance to earn a profit (counting from when you adjusted the position, and not counting from the time when the original trade was made).

What is an adjustment?

An adjustment for any option position consists of any trade that accomplishes EACH of these objectives:

1. Imminent risk is reduced. In other words, if the price of the underlying asset continues to move in its current direction by a specific amount, you will lose significantly less money after making the adjustment compared with the unadjusted position. NOTE: It is not necessary to remove all risk every time an adjustment is made. The objective is to convert the position into one that is comfortable to hold.

--To meet this objective,

reduce delta exposure. In other words, when the position is short delta, add some positive delta to the position. When long delta, add some negative delta to the position.

--Add positive delta by buying calls or call spreads. Add negative delta

by buying puts
or put spreads.
I urge you not
to sell
additional put
or call spreads
to pick up the
needed delta –
because that
increases
ultimate risk. If
you insist on
selling, rather
than buying
spreads, please
cover the
current short
call (or put)

portion of the
iron condor
before selling
more call (or
put) spreads.

--That
'specific
amount'
depends on
your comfort
zone and how
rapidly money
will be lost if
you do not
adjust.

--I suggest two
alternatives for

deciding how much that specific move should be:

--Percentage.

Perhaps 1, 2 or 3%. Look at a risk graph to see how much money would be lost on a rally/decline.

Choose a percentage such that the potential loss is well within your

acceptable
limit. You
always want to
take defensive
action before
any loss is
large enough to
make you
uncomfortable
(i.e., angry
with yourself
for not taking
steps to reduce
risk earlier).

--Standard deviation (SD). One or 1.5
standard deviations

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C
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-- If RUT
rallies to 1204
today, 1206
tomorrow ,
1210 the next
day, and 1215
one day later—
a 15-point
move that may
leave you

believing that
none of those
price changes
was large
enough to
trigger an
adjustment on
its own. That is
an
inappropriate
conclusion.
However do
not
automatically
adjust:

If your
decision is to
consider

adjusting every
time that RUT
moves one (or
some other
quantity)
standard
deviation, then
once RUT hits
1211 (or 1189)
take another
look at the risk
graph. Do not
make an
automatic
adjustment.
Determine
whether that
adjustment is

still needed.
NOTE: It may
not be needed
because the
passage of time
often makes the
position much
less risky to
own at 1211
now, than it
would have
been a few
days ago.
Calculate a
new adjustment
point and
ignore the
previous

calculation.

--This may seem complicated, but all you are doing is deciding every day where to adjust today, if something unwanted happens to the price of your underlying asset. There is nothing special about 1.0, 1.5, or any other

number of
standard
deviation
moves. Traders
use these
numbers as a
reminder to
pay attention to
the price
changes,
encouraging
them to take a
fresh look at
the current risk
profile – after
such a move
occurs.

--This may

seem
complicated,
but all you are
doing is
deciding every
day where to
adjust today, if
something
unwanted
happens to the
price of your
underlying
asset.

2. The newly adjusted position must still satisfy the premise of owning any option position.

--You are

pleased to have
the position in
your portfolio.

--The
probability of
earning a profit
(from this point
in time into the
future) is good.

--The possible
profit is good
enough to
justify current
risk.

--Most
important of all
is being sure

that you did not
make this
adjustment for
the sole
purpose of
avoiding the
unhappiness
that comes with
locking in a
loss. It is far
better to take
the loss and
open a brand-
new position
that meets all
of your
investment
criteria.

3. The position being adjusted is worthy of salvage. Some positions can become unwieldy (i.e., after an adjustment or two, it may contain too many different options) to manage. Other positions may be too stressful to manage simply because you spend too much time worrying about what to do next. Don't be concerned with these position types. Unload them and find new trades. Reducing risk is the primary objective when adjusting, but reducing stress is another worthwhile goal.

4. Prime Directive:

*****The trade
that you make
as an***

*adjustment
MUST earn
money as a
standalone
trade
whenever the
original
(currently
threatened)
trade
continues to
lose money.
Never create a
position such
that it is
possible for
the*

*adjustment to
lose money at
the same time
that the pre-
adjustment
position
continues to
bleed money.
NEVER. ***

The adjustment does NOT have to earn more than the original trade loses. It just has to offset PART of that loss. If you prefer to offset the entire loss, then it is better to simply exit the trade. Adjustments are hedging trades that are intended to reduce losses, not eliminate them.

This is the whole idea behind adjusting. The adjustment must earn a profit to offset at least a portion of any additional loss that accrues to the original position.

It is not good enough when the risk graph looks good. The adjustment trade (if it were a standalone trade) must never lose money when the original trade is losing money. That is the reason why buying farther OTM options is unsuitable. The passage of time and a small market move (in the wrong direction) would increase the loss.

It is not good enough to examine what happens at expiration. Nor is it good enough to calculate what happens the day of the adjustment. The adjustment

trade must earn some profit when the original trade loses money.

Chapter 19

Advanced Risk Management: Examples

There are always a bunch of alternative strategies that you can use when adjusting an iron condor position. Remember that the adjusted position must be less risky to own than the pre-adjustment position.

When it comes to adjusting iron condors, please recall the suggestion that iron condors should be managed as if they were two separate positions. In the text below, when I refer to the “threatened”

side or the “at risk” portion of an iron condor, that reference is to either the call spread as the market rallies, or the put spread after the market declines.

There is one overriding rule for adjustments:

*****Do not add risk. Do not increase position size.***

Be certain that the newly adjusted position cannot result in a larger

Exception: If you are under-invested, it is acceptable to increase position size.

For example, if you usually own 10-lots of three different, 10-point, iron condors simultaneously, then your normal allocation is 30 10-point iron condors. If you have only two such positions and one requires an adjustment, it is acceptable to bring your total (for all positions) up to 30-lots. In other words, you may—if the trade is very appealing—adjust the threatened iron condor so that it becomes a 15- or 20-lot position. I'll discuss how this works in one of the examples below.

DO NOT abuse this exception because it is far too easy to blow up a trading account by continuing to sell extra spreads. Sure it feels good to bring in extra cash, but you know that it is not sane to expect every option to expire worthless. Why would you want to allow for the possibility of taking a bit hit when an unexpected rally or market debacle occurs?

Important
NOTE: The ideas below are presented with sufficient detail that you can adopt any

of them with confidence (when you are certain that you understand the purpose behind making the adjustment trade). There are no shortcuts in the descriptions. However, the serious trader may discover that he/she still has questions. A topic such as

managing iron
condors
includes so
many details
that it requires
a lengthy book
of its own.

Strategy 1. Cover

Cover positions that are very “cheap.” If either the call spread or the put spread reaches a very low value (difficult to define, but it can be \$0.05 to \$0.20, depending on how much time remains and the premium that you collected when opening the position), buy it. There is too little residual potential profit for you to take the risk of remaining short that spread.

If for example, the market is falling and the put spread is getting into trouble and you are thinking about making a risk-reducing adjustment, it probably makes sense to pay \$0.10 to \$0.20 cents to cover the call spread. The primary rationale is to avoid risk when there is almost nothing to be gained. Holding onto this position because it is so far out of the money is not a good idea when it costs so little to cover.

When the market has moved far enough in either direction that money has been lost, and the losing portion of the iron condor requires an adjustment, do not be afraid to spend a small amount of cash to cover the other portion of the original iron condor. It is easy to tell yourself

that you already lost money on this trade and you refuse to add to the overall loss by spending any money on the cheap spread. Do not believe that it is worth the risk associated with waiting for the options to expire worthless.

Strategy 2. The Replacement Spread

If you do cover a short spread as described above, there is a prudent adjustment method available. It is not something that has to be done, so be sure to decide whether this is appropriate for this specific set of conditions.

The sole purpose behind this adjustment is to turn your current position into one that is closer to market neutral. It will not be delta neutral, but this adjustment

is closer to market neutral than the pre-adjustment position. This method is not suitable for every trader, so if you do decide to adopt this idea, please be very careful to follow all suggestions below.

Of all the strategies mentioned in this chapter, this one produces the least amount of risk reduction. It is still acceptable under the right conditions and you should understand how it works. However, it does not reduce negative gamma and the “at risk” portion of the iron condor remains just as risky as it was.

--Sell another
spread
(obviously, if

you just
covered the
call spread,
that means sell
another call
spread).

--DO NOT
anticipate. In
other words,
do not sell the
new spread
unless the
spread being
replaced has
already been
bought. The
disciplined
trader may sell

the new spread
first, but ONLY
when he/she
immediately
purchases the
spread being
covered.

Bidding is not
good enough. If
you are not
sure you can
cover at a
price that you
are willing to
pay, then be
conservative
and cover first
and sell the

replacement
spread second.

--The new
spread should
have the same
expiration date
as the covered
spread.

--The new
spread must
leave you
comfortable
with the new
risk. This is
important: If
you just
covered the

call (or put)
spread, then
you have zero
upside (or
downside)
risk. Thus,
selling this
new spread
reintroduces
upside
(downside)
risk.

--The premium
must meet
some minimum
standard. You
do not want to
introduce

upside (or downside if the trade involves puts) risk for a small reward.

****VITAL**

MINDSET:

Never think of this trade as a way to cut losses if the market continues to move in its current direction. The premium

available by rolling a call or put spread is just too small to act as a meaningful hedge when the market continues its current trend.

This trade is made for one reason only: You do not have a market bias and want to convert the

*position to one
that is closer
to delta
neutral. ***

Many times there is nothing suitable to sell and your choice becomes holding or choosing another adjustment strategy.

a. The time remaining before expiration arrives should not be too short because the premium will be too small and the negative gamma will be too high. This “sell a replacement spread” is not feasible when less than two weeks remain in the lifetime of the options. In other words, if you are trading weekly iron condors, this is not a good adjustment strategy.

b. Repeating a crucial message: You must avoid a losing way of thinking. Make this trade only when you want to bring the position closer to neutral. Do not make this trade believing that it is free money (because you think the market will continue to move in its current direction. If you believe that to be true, then get out of the entire iron condor because it is not a suitable strategy when you have a significant bullish or bearish market bias.)

*****Never sell
this
replacement
spread unless***

*you have
already
covered the
father out-of-
the-money
cheap spread.

Strategy # 3a. Buy expensive delta and gamma

When the market is moving one way and the position is becoming too risky for you to own it as is, then make an adjustment by cutting risk. The most effective way to do that is to reduce both delta and gamma risk. That is accomplished by buying something.

You can buy individual options: Buy puts when the market is falling and your position has too many positive deltas; buy calls when the position has too many negative deltas. The problem with this idea is that the calls and puts are expensive and you may be unwilling to spend so much cash to protect a position from danger.

*****One***

Warning: One

Warning:

Never (that

means never)

buy options

for protection

when they are

*farther out of
the money
than the
option you are
currently
short.***

EXAMPL

When buying those “farther out-of-the-money than your current short” options, the risk graph may look good, but the risk of losing a lot of money increases. So why does the risk graph look so good? Because it shows what happens on a gigantic market move.

Owning extra options always looks good when the market cooperates. However, in the vast majority of cases, the market does not rally/decline by 10 to 20% just

because you own a few extra OTM options. The most likely event is that those options will expire worthless.

This is not a big deal when the options are bought for speculation. If you want to take a chance and buy those cheaper, far OTM options, go for it. You will lose almost every time, but may get lucky once or twice. But, when buying options for PROTECTION -- when buying options to REDUCE RISK -- these options are unsuitable.

The problem with buying protection for very uncommon events (the big move) is that money will be lost on the vast majority of trades. Trades that are intended to reduce risk should reduce

risk 100% of the time. They should not contribute to the possibility of additional losses.

If time passes and the market continues its rally (or decline), here is what will happen when your adjustment consisted of buying options that are farther OTM than your short options: The options you bought will still be OTM and will lose value. The spread you are short will (possibly) move ITM and its value will increase. As a result, you not only failed to reduce losses for the at-risk portion of the iron condor, but the adjustment trade results in an additional loss.

That is not acceptable when adjusting a position.

Strategy #3b. Buy less expensive delta and gamma

Instead of buying puts or calls, you can buy a small number of put or call spreads.

Buying option spreads: Buy put spreads when the market is falling and your position has too many positive deltas; buy call spreads when the market has been rising and your position has too many negative deltas. The protection is limited, in contrast with buying single options where the protection is unlimited. However, it costs far less to adopt this adjustment strategy, and that is important.

EXAMPL

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EXAMPLE

--XYZ (same
expiration)
1225/1215 put
spread

--XYZ (same
expiration)

1220/1210 put
spread

--etc.

*****Big***

warning: Do not pay too much for the spread. If you buy a 10-point call spread, the most it can ever be worth is 10 points, or \$1,000. If you pay \$800, then you add \$800

*worth of
downside risk
and all you
gain is \$200
worth of
upside
protection.*

*Suggestion:
Limit the
purchase price
for any spread
(that is bought
for the
purpose of
reducing risk)
to 40% of its
maximum*

value. That means pay no more than \$4 for a 10-point spread, \$2 for a 5-point spread, or \$0.40 for a 1-point spread.

Strategy #4. The pre-adjustment

I like the idea of owning a position that comes with a built-in adjustment for those times when you fear a market move, but still want to own an iron condor position.

For example, instead of selling 10 put spreads and 10 call spreads, initiate the trade as if you already made an adjustment:

When SPX is trading at 1950, and you fear a severe market correction, you could make this trade:

Sell 7 (or 8) 1890/1900 put spreads and
Sell 10 1990/2000 call spreads

That sample iron condor assumes that an adjustment has already been made. In other words, the iron condor began life as a 'normal' 10-lot position, but that you bought 2- or 3- lots of the put spread as an adjustment.

NOTE: The

short put is 50-points out of the money and the short call is 40-points out of the money. This is a common situation when traders prefer to initiate the trade with a position that is near delta neutral. Traders who prefer “distance

neutral” would choose the 2000/2010 call spread instead.

Strategy #5. The Broken-Wing Iron Condor

Another example of a pre-adjusted iron condor is the “broken wing” variety. The trader elects to open a broken-wing position instead of a regular iron condor.

This iron condor variety uses the strategy of skipping one or more strike prices. This is not a market neutral position because risk is greater to either the up- or downside.

EXAMPL

NOTE: If
you are
familiar with
the concept of

equivalent
positions, you
know that the
20-point
spread is
equivalent to
two 10-point
spreads. Thus
the BWIC
above is the
same as an
ordinary iron
condor in
which 16 (eight
each of the
1880/1890 and
1890/1900)
10-point put

spreads but
only 8 of the
10-point call
spreads are
sold.

Strategy # 6. The OTM calendar spread

This adjustment strategy is included for the sake of providing a variety of methods. However, the user must be very careful because it is possible to violate the [Prime Directive](#) when buying OTM calendar spreads.

The trade: Buy a calendar spread with a strike price that is near the strike price being protected. The calendar spread may be a little less far OTM, or a little

further OTM.

EXAMPL

Calendar spreads gain value when:

1. The underlying asset moves from its current price and approaches the calendar spread strike price.
2. Additional profit is earned when time passes and #1 is true.
3. Conclusion: As the price of XYZ moves toward the strike price of one of the short options, the iron condor is usually losing money. However, the

calendar spread slowly earns money that partially offset losses.

Important facts about buying OTM calendar spreads:

--Call spreads are bought to gain upside protection. Put spreads are bought to provide downside protection.

--Protection is limited. Do not adopt this

strategy when you fear a substantial rally or decline. When the underlying continues to move beyond the calendar's strike price, the accumulated profits tend to disappear.

-- This strategy is very dependent on the implied volatility of the

options. Thus,
in general,
expect it to
provide less
protection
when

protecting the
call side of the
iron condor (IV
declines on
most rallies)
and to work
better when
protecting the
put side of the
iron condor (IV
tends to
increase on

market
declines).

--Calendar
spreads begin
to lose value
once the
options move
into the money.

Translation:

DO NOT
CONTINUE
HOLDING
THE
CALENDAR
SPREAD
ONCE THE
OPTIONS
ARE ITM OR

ALMOST ITM
because that
violates the
[prime](#)
[directive](#). On a
further rally (or
decline), the
iron condor
would continue
to lose money
as the calendar
spread begins
to lose value.

This trade can be used effectively, but it cannot be used often. The ideal market conditions are quite limited.

Strategy #7. Selling Extra Option

Spreads

This strategy has a lot of appeal, especially for traders who fall into one of two categories:

--The less-experienced trader.

--The trader who does not fully grasp the concept of risk.

EXAMPL

Why this trade is appealing:

-- The adjustment can be made without spending much cash. When implied volatility (IV) is high, the “roll down” trade can be made for a cash credit. In other words, it does not cost any out-of-

pocket cash.
When IV is
much lower,
you must pay a
small debit to
make the trade.

This is
attractive to the
trader who
hates to spend
cash on any
adjustment.

NOTE:

Spending cash
is not a bad
thing because
the adjustment

is made to
reduce risk. Its
primary
purpose is to
avoid taking a
substantial loss
and not to
search for a
chance to exit
(eventually) the
trade with a
profit. It may
“feel safer” to
be short
spreads that
are farther
OTM than they
were pre-

adjustment, but
being short
twice as many
is a losing
strategy
(Martingale)
over the
longer-term.

Why this trade is unappealing (i.e., too risky)

--It is not
“much safer” to
be short twice
as many
options (or
option
spreads). True,
the probability

of losing
additional
money is far
less, but the
amount at risk
is far more. Do
not confuse “a
high
probability of
earning a
profit” with
“safe.” To me,
a safe position
is one for
which the
worst-case
scenario
results in an

acceptable, not
a portfolio-
destroying,
loss.

--It exposes
you to a loss
that is much
larger than
your original
trade plan
allows. If you
abandon the
plan to take on
additional risk,
that will
become a bad,
difficult habit
to break.

--The trader learns to depend on a doubling-down approach based on the [Martingale system](#). The strategy has the gambler double the bet after every loss, so that the first win recovers all previous losses plus a profit equal to the original

stake. Unless you have an infinite sum to invest, the odds are high that you will eventually go broke.

--Although doubling position size from 6 to 12 (in this example) is not a terrible idea in itself, the problem occurs when this trade

has to be adjusted two more times and you find that the margin required to carry a 48-lot position is beyond your means. The trader who successfully adopted this strategy one time will be anxious to adopt it again and again – and

that begs for trouble.

--The only time that I recommend this strategy occurs when you are underinvested and increasing position size for one specific trade keeps your portfolio within its position-size limit.

The bottom line for adjusting positions is that the iron condor must be adjusted into something worth owning. When position delta and gamma are reduced (i.e., you bought options or spreads), the adjustment will serve its purpose.

The risk-management ideas in this chapter should be more than enough to get you started as a risk manager.

Afterword

The purpose behind preparing this volume is to give readers a very solid understanding of the iron condor and how to make each of the important trade decisions. That includes some ideas on specific trades to manage risk.

It is important to mention that this is not intended to represent a complete course on trading iron condors. My goal is to provide more than enough information for readers to understand how the trade is supposed to work and what can be done when the trade goes awry.

Most importantly, I hope I have

introduced you to concepts not found elsewhere in the options-trading literature and that you will use these ideas to your advantage. I believe it is helpful to understand the experienced trader's mindset as trade decisions are being made. When those thoughts make sense, you have a plan to follow – at least when getting started. When those thoughts don't feel quite right, you have an opportunity to make changes. The benefit to every reader is that this education process gets you thinking about the whole strategy. Too often a book and its lessons are taken as gospel and the reader becomes a rote trader, rather than a thinking trader.

There is more to learn about this

strategy, and much of that will come from your own trading experiences and perhaps in discussions with other traders.

I encourage you to think for yourself and not to accept everything that you read or encounter on the Internet as The Truth.

Good trading to all.

Appendix A

Probability of Touching

As iron condor traders, you will often want to get a good handle on the likelihood that the short options will expire worthless. The corollary is the probability that an option will expire in the money. Note that this probability ignores the stock price between the present time and that future expiration date. It is only concerned with the expiration price.

Unless you are a trader who always (and inappropriately, in my opinion) holds

positions through expiration, there is a different probability number – one that is far more relevant when trading iron condors. That is the “probability of touching,” or the odds that the stock price will reach (i.e., touch) a specific price at any time on, or prior to, a future date. This specific price is most often the strike price of the short options in the iron condor, but the calculation can be made for any price using any future date.

For example, you may want to know the chances that the stock will trade at any price within the next week or two (or any other date).

‘Probability of Touching’ Calculators

Fortunately calculators that generate the

necessary numbers are readily available. Your broker may have a 'probability of touching' calculator. If not, I like [the one offered](#) by Peter Hoadley. It is free to use, but the free version allows only a few calculations per session.

Why is this calculator worth using?

The inexperienced iron condor trader looks at the delta of the short options (assume it is 8) of an iron condor and correctly decide that the chances of that specific (call or put) option being in the money when expiration arrives is 8%. He may incorrectly conclude that (if held to expiration) this iron condor will expire worthless 92% of the time.

The first problem is that each short

option has an 8% chance of being in the money. Thus, if held until the options expire, the position expires worthless only 84% of the time. In other words, one of the options will be ITM for 16% of the trades.

The second, and more important, problem is that markets do rally or decline without waiting for expiration to arrive. Thus, the call or put spread may move into the money before expiration. When that happens, the trader is unlikely to continue to own the position and will very likely exit. The probability that this occurs cannot be ignored. Also consider that the short option does not have to be ITM before the position becomes too uncomfortable for most traders to hold.

Thus, the position may be worthless at expiration 84% of the time, but a good risk manager will never hold that position that often. There are always going to be instances when you elect to get out of the trade just because it has become too risky to hold.

Thus, the 84% (expiring worthless) number is not of practical use. The probability of touching the strike price is far more important because it tells you how often you can anticipate holding until your preferred exit date (expiration or perhaps one or two weeks earlier).

*****The
thinking
trader can use***

*this calculator
to generate
even more
useful
information.

EXAMPL
(using the
[Hoadley](#)
[calculator](#)

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These calculations provide great information on what to expect over the course of the trade. Obviously these are probability calculators and they cannot be used to predict the future.

Hoadley Probability of Touching Calculator

45-day; 15-Volatility Iron Condor

Hoadley Probability of Touching Calculator

45-day; 25-Volatility Iron Condor

Hoadley Probability of Touching Calculator

21-day; 15-Volatility Iron Condor

Current stock price: 850.00

Upper boundary price: 880.00

Calendar days: 21

Expected return on stock: [Help](#) 1.50 % pa

Hours/trading day: 6.5

Calculate

Lower boundary: 820.00

Volatility: (>1%) 15 % pa

Dividend yield: 0.00 % pa

Trading days/year: 252

Probability functions are available in the [Finance Add-in for Excel](#)

Probability Analysis

Measure	At period end	At any time during the period			
	At end of day 21	Assuming continuous monitoring of prices	Prices monitored hourly each trading day	Prices monitored once per trading day	Prices monitored once per week
Probability of price being above upper boundary price	16.90%	33.70%	30.77%	26.57%	
Probability of price being below lower boundary price	15.75%	31.60%	28.79%	24.77%	
Probability of price touching either boundary price		64.65%	59.20%	51.21%	
Probability of price touching neither boundary price		35.35%	40.80%	48.79%	
Probability of price touching both boundary prices		0.65%	0.36%	0.13%	
Probability of price being between boundary prices	67.35%	100.00%			

Figure A.3

Most rookie iron condor traders fail to

recognize – because it is not a common situation – that the market may occasionally force them to exit one part of the iron condor and then reverse direction and wreak havoc on the remaining side. The probability of touching calculator can be used to see just how likely that is to occur. It is the “probability of price touching both boundary prices.”

To avoid that catastrophe, I urge you to cover the call or put spread at a low price at the same time that you faced the unhappy prospect of taking a loss on the other portion of the iron condor. I understand how painful it can be to spend a little more cash when you just had to cover the other half of the iron

condor. But this small sum is money well spent, even if it is just for peace of mind.

Thank you for buying Iron Condors.

Join my [e-mail list](#) for occasional updates:

Visit [my blog](#):

For 1,000 great articles about trading options.

Special promotions and discounts.

Information on

new books.

Ask questions: rookies (at) mdwoptions
(dot) com

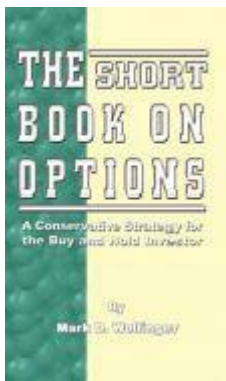
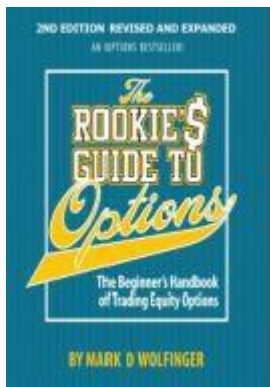
Other Books by Mark D Wolfinger

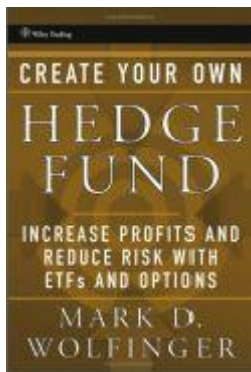
My Dead-Tree Books

The Rookies Guide to Options, 2nd Edition (2013)

Create your own Hedge Fund (2005)

The Short Book on Options (2002)





The Best Option Strategies Series of eBooks

Book One. (Volume 0) Intro to Options: The Basics (2014).

Book Two. (Volume 1) Writing Naked Puts (2014).

Book Three (Volume 2) Iron Condors (2014).

THE BEST OPTION STRATEGIES
A "Hands On" Guide to
Making Money with Options

Volume 0

INTRODUCTION TO OPTIONS THE BASICS

MARK D. WOLFINGER

THE BEST OPTION STRATEGIES
A "Hands On" Guide to
Making Money with Options

Volume 1

WRITING NAKED PUTS

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Volume 2

IRON CONDORS

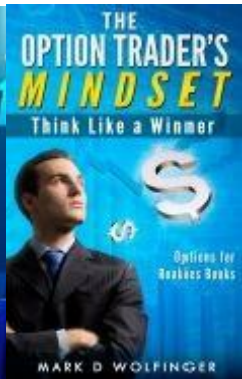
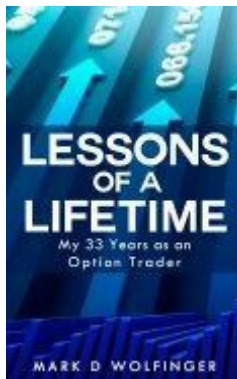
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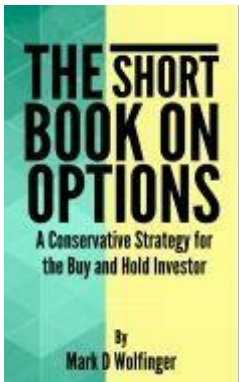
My other eBooks:

The Short Book on Options (2002, 2014)

The Option Trader's Mindset: Think like a Winner (2012)

Lessons of a Lifetime: My 33 years as an Option Trader (2010)





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bookseller.**

About the Author



Mark Wolfinger has been in the options business since 1977, starting as a market maker on the trading floor of the Chicago Board Options Exchange. He is now an author and educator of individual investors, specializing in the conservative use stock options.

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He writes on options for about.com:
<http://options.about.com>